

2002

Proposal for a Centralized and Integrated Registry for Security Interests in Intellectual Property

William J. Murphy

University of New Hampshire School of Law, william.murphy@law.unh.edu

Follow this and additional works at: https://scholars.unh.edu/law_facpub



Part of the [Business Law, Public Responsibility, and Ethics Commons](#), [Corporate Finance Commons](#), [Finance and Financial Management Commons](#), [Intellectual Property Law Commons](#), [Other Law Commons](#), [Secured Transactions Commons](#), and the [Technology and Innovation Commons](#)

Recommended Citation

William J. Murphy, "Proposal for a Centralized and Integrated Registry for Security Interests in Intellectual Property," 41 IDEA 297 (2001-2002).

This Article is brought to you for free and open access by the University of New Hampshire – School of Law at University of New Hampshire Scholars' Repository. It has been accepted for inclusion in Law Faculty Scholarship by an authorized administrator of University of New Hampshire Scholars' Repository. For more information, please contact ellen.phillips@law.unh.edu.

TABLE OF CONTENTS

VOLUME 41 – NUMBERS 3 & 4

Article:

**Proposal for a Centralized and Integrated Registry
for Security Interests in Intellectual Property**

William Murphy.....297

Proposal for Security Interests in Intellectual Property

PREFACE

As the world economy enters the twenty-first century, job and wealth creation is increasingly based on innovation and creativity that, in turn, can give rise to important intellectual property rights. For many companies and individuals these intellectual property rights may represent their most valuable assets, or in some cases, their only valuable assets. As a result, intellectual property rights increasingly play a critical the role in financing.

Unlocking the job and wealth creating potential of intellectual property assets requires putting these assets into use, and that often requires a capital investment. Unfortunately, many entrepreneurs and innovators lack the capital necessary to develop business and products based on their creativity and innovation and must turn to outside sources for funding. As part of the funding the providers of capital generally require collateral. This poses little problem if the collateral is in the form of real estate or tangible property. When the assets are in the form of intangible property, specifically patents, copyrights and trademarks, the creation and perfection of a security interest in the assets is significantly more uncertain and difficult. As a result of this increased uncertainty and difficulty, the availability and cost of capital for Information Age individuals and organizations is negatively affected.

Pursuant to a cooperative contract between the United States Patent and Trademark Office and the Franklin Pierce Law Center, together with the University of Maine School of Law, the University of New Hampshire Whittemore School of Business and the law firms of Rath, Young & Pignatelli, Devine, Millimet and Branch, and Nixon Peabody, a talented group of individuals was amassed to assess the problem and explore potential solutions. This resulting report analyzes the current situation regarding security interests in intellectual property and proposes action that can greatly reduce the uncertainty surrounding the use of intellectual property as collateral. While an important and necessary first step toward a solution, the proposals in this report will require additional research, legislative, and administrative attention for implementation.

Every project has a cut-off point. This report was completed in the late spring of 2001 for submission to the United States Patent and Trademark Office. As a consequence, significant later developments are not included. For example, the appellate decision in *In re Cybernetic Services, Inc.* [239 B.R. 917 (9th Cir. B.A.P. 1999, *aff'd*, 252 F.3d 1039 (9th Cir. 2001)] was handed down after the report was completed. In an important and evolving field such as that covered by this report, it is an unfortunate reality that some significant actions will occur after the "books have been closed."

I would also like to thank each of the following individuals who have kindly assisted in the production of this report especially my co-reporter, Professor Thomas M. Ward of the University of Maine School of Law. I would also like to thank the various institutions and law firms for whom the project members' work for their donation of time and supporting resources. I would particularly like to thank two alumni of Pierce Law for their help in the project, the Project Manager, Maura Weston, a partner at the Concord, New Hampshire law firm of Rath, Young & Pignatelli, for her dedication and managerial talent for bringing the disparate elements of the project into a coherent whole. A special thanks is extended to Bonnie Boulanger, former LLM student and now an attorney with the Salem, New Hampshire law firm of Hatem & Donovan, who provided expert editorial support and a fresh pair of eyes at a critical juncture.

William J. Murphy
Project Director

Proposal for Security Interests in Intellectual Property

CONTRIBUTORS

Rath, Young and Pignatelli

Maura Weston, Esq. (Project Manager)

Diane Vlahos

Lexis-Nexis

Paula Sicard, Esq. (Researcher Coordinator)

Devine, Millimet & Branch

Paul C. Remus, Esq.

Nixon Peabody

Jamie Hage, Esq.

Dan Sklar, Esq.

Harry C. Sigman, Esq. (International Commercial Lawyer and
Member of the Drafting Committee for Revised U.C.C. Article 9)

Pierce Law - Franklin Pierce Law Center,

William Murphy, Professor, Project Director and Co-reporter

Bonnie Boulanger, Esq. (LLM 2001)

Chang Hong (JD Candidate 2002)

Todd Wilson (JD Candidate 2002)

Tom Wolf (JD 2001)

University of Maine School of Law

Thomas Ward, Professor and Co-reporter

Lois Lupica, Professor Jim Friedman, Professor

Dennis Carrillo (JD Candidate)

A.J. Hungerford (JD Candidate)

University of New Hampshire Whittemore School of Business and
Economics

John Freeear, Professor

Jeffrey E. Sohl, Professor

A.R. Venkatachalam, Professor

EDITOR'S NOTES

1. The following proposal was submitted in May of 2001. The proposal is published without revisions by the IDEA editorial staff.
2. Eric Douma, *Fair Use and Misuse: Two Guards at the Intersection of Copyrights and Trade Secret Rights Held in Software and Firmware*, initially scheduled to appear in this issue, will be published in 42 IDEA 37 (2002).

CONTENTS

I. Abstract.....	297
II. Market Transactions.....	301
A. The Role of Intellectual Property in Market Transactions.....	301
B. Market Imperfections and Inefficiencies.....	306
III. Overview of the Legal Systems Affecting Intellectual Property As Collateral.....	309
A. The Federal Title System.....	309
1. Copyrights.....	310
2. Patents.....	310
3. Trademarks: The Lanham Act.....	311
B. The State Encumbrance System.....	313
1. Classification of Collateral.....	315
a. Intellectual Property Generally.....	315
b. Receivables.....	317
c. Accounts.....	318
d. Proceeds.....	319
2. UCC Article Nine: Attachment.....	320
a. Attachment as Predicate for Perfection.....	320
1. Elements of Attachment.....	321
b. Perfection and Choice of Law.....	323
3. UCC Article Nine: Priority Rules.....	324
4. UCC Article Nine: Deferral to Federal Law.....	325
a. Complete Step-Back Provision.....	325
b. Partial Step-Back Provisions.....	327
IV. The Current Confusion.....	327
A. Intellectual Property Law: The Copyright Act.....	329
B. Federal Intellectual Property Law: The Patent Act.....	332
1. Deferral to the Patent Act.....	337
2. Preemption of Article Nine under the Patent Act.....	338
C. Federal Intellectual Property Law: The Lanham Trademark Act.....	339
1. Partial Preemption.....	341
2. Title Document Transfer: the <i>Clorox</i> Case.....	343
3. Assignments.....	344
4. Subsequent Purchaser.....	345
V. Model Legal and Technological System Structure.....	347
A. Model Technological System – Basic Elements and Premise.....	347
1. Background.....	347
a. Technology Based Changes in Revised Article Nine...	349
1. Media Neutrality.....	349
2. Signatures.....	349
3. Central filing.....	349
4. Where to file.....	349

Proposal for Security Interests in Intellectual Property

5. Standard Forms.....	349
b. Possible One-Stop Shop System.....	350
B. Proposed Technological System Solutions.....	350
1. Solution Requirements.....	350
a. Single point entry for search criteria.....	350
b. Single point electronic payment system.....	350
c. Interactivity.....	350
d. Web-based interface.....	351
e. Personalization.....	351
f. Security.....	351
g. Organized presentation of results/information.....	351
h. Inclusion of all applicable data sites (state & federal).....	351
C. Ideal Technological Solution.....	351
D. Next Best Solution.....	352
E. Proposed Solution.....	352
1. Technical Requirement.....	353
2. Operational Requirements.....	354
3. Usage Charges and Disbursement.....	354
a. Equal portion to each state.....	355
b. Proportional to number of records returned.....	355
c. Fixed and variable method.....	355
F. Conclusion.....	356
VI. Recommendations – Alternative Legislative Models Based on Recommended System Structures.....	356
A. Model Acts – Basic Elements and Premises.....	356
1. The Problem and the Three Proposed Legislative Solutions... ..	356
2. Notice Filing.....	358
3. Integration of Financing Statement Information.....	358
4. A Single Database or Web-Based Meta-Site Under a Single Agency.....	358
B. Model Acts – Three Different Levels of Federal Involvement in Perfection and Priority.....	359
1. Model 1.....	359
2. Model 2.....	360
3. Model 3.....	361
C. Model Acts – Other Problems and Provisions for Cure.....	362
1. Reform of the Priority Rules for Transferees using the Federal Tract Files.....	362
2. The Federal Transfer Statement.....	363
 Appendices	
1 Intellectual Property Collateral Coordination Act.....	365
2 Intellectual Property Security Interest Coordination Act.....	387

IDEA – The Journal of Law and Technology

3	Security Interests in Intellectual Property Restoration Act.....	405
4	Markets.....	421
5	The Secondary Market Function.....	429
6	Due Diligence.....	445
7	Exclusive and Nonexclusive Licenses.....	465
8	Software.....	469
9	In re SSE International Corp.....	475
10	Commercial Tort Claims.....	477
11	Intellectual Property as Collateral.....	481
12	UCC Article Nine: Perfection.....	497
13	Location Rules for General Intangibles.....	511
14	Application of Priority Rules.....	513
15	Peregrine and Avalon.....	525
16	World Auxiliary Power.....	545
17	The History of the BFP Rule.....	549
18	Section 261: Theories of Displacement.....	551
19	Waterman v. Mackenzie.....	561
20	Patent Act Preemption Cases.....	563
21	Analysis of UCC Filing Procedures for Selected States.....	571
22	Recording (State) System for Trademarks.....	575
23	Recording (Federal) System for Trademarks.....	579
24	Recording Proposed Technological System Solution.....	581
25	Pending Federal Reforms.....	585
26	The Effect of Bankruptcy on a Firm Using Intellectual Property as Collateral.....	585
27	Definitions.....	601

PROPOSAL FOR A CENTRALIZED AND INTEGRATED REGISTRY FOR SECURITY INTERESTS IN INTELLECTUAL PROPERTY

I. ABSTRACT

Entrepreneurial energies are often focused on developing various forms of intellectual property, either as part of products or processes to produce products. These products or processes may involve a combination of patents, copyrights, trademarks, trade secrets and other intellectual property. Currently, the more relevant and valuable assets in our knowledge-based economy are in the form of intellectual property rather than buildings and machinery. The characterization of intellectual property as a significant business asset should make a company's intellectual property, in turn, among the assets most valuable and useful as collateral in obtaining financing. Economic growth, in our knowledge-based economy, is in large part driven by the ability to leverage the value of such assets.¹

Despite the fact that in today's knowledge-based economy intellectual property is often a company's most valuable asset, it is routinely under-valued and under-utilized, a situation which arguably stunts economic growth. The under-utilization of intellectual property in transactions results from the uncertainty created by current legal structures and regulatory regimes surrounding the use of intellectual property as collateral. This translates into difficulties for an entity seeking to leverage the value of intellectual property assets, creating a disincentive to do business.

Secured financings involving intellectual property are currently caught between the statutory schemes governing intellectual property rights, essentially a federal title system, and the UCC Article Nine state encumbrance system. The complexity and confusion resulting from the interplay of these two systems drives away potential financiers and prevents companies and individuals from extracting the full value of their intellectual

¹ See Michael A. Barr, Financing Alternatives for Dot.Coms, *THE M&A LAWYER* 27, December 2000.

property assets. This report examines the relevance of intellectual property in financing transactions, and the present structural obstacles to leveraging the value of intellectual property in secured transactions. This report then proposes three statutes that would help eliminate these obstacles by creating a centralized or integrated registry for security interests in intellectual property and a proposed technological solution for the implementation of that registry. [See Appendix 1, Appendix 2 and Appendix 3.] Given the significant value of intellectual property assets and their vital role in business transactions, the creation of a centralized or integrated registry is paramount to the continued vibrancy and growth of our knowledge-based economy.

Security agreements are the mechanisms that drive secured financing. In a security agreement, the debtor grants the creditor a security interest in an asset offered as collateral, allowing the creditor to gain ownership of that asset should the debtor default. While security interests are enforceable between parties to the agreement, creditors wishing to defend against competing third party interests must notify the general public of their security interest in the debtor's collateral. The creditor's public notification is known as perfection. A perfected security interest assures creditors priority over subsequent third party claims to the collateral. This process, known as secured financing, allows creditors to retain enough control over collateral assets to protect their value upon liquidation, while allowing the debtor to retain title to and maximize the value of these assets.

Accessible collateral with predictable value is the lynch-pin of traditionally secured financing since it reduces a creditor's financial risk. However, when collateral takes the form of intellectual property a creditor's risk may actually be increased. Historically, collateral has taken the form of "hard assets" such as machinery and equipment, inventory, and real estate. State rules and procedures governing creditor interests in these industrial-age assets are well established. Creditors are experienced at valuing industrial-age assets, drafting security agreements encompassing these assets, and properly perfecting the resulting security interests. Judicial treatment of conflicts involving multiple creditors having security interests in the same tangible asset is relatively clear-cut and consistent. As a result, most creditors are comfortable with the valuation and liquidity of industrial-age assets used as collateral to satisfy debt. Problems arise when creditors seek to secure collateral involving intellectual property rights however, because the federal statutes governing these rights inevitably collide with the state statutory schemes governing creditor interests in collateral. Current state perfection rules and procedures are generally well conceived but were not designed to handle chimera-like information-age assets. Judicial treatment of conflicts between state and federal law and of conflicts between multiple creditors having security interests in the same information-age asset is confusing and conflicting. Creditors are unsure which statutory scheme governs the

perfection of intellectual property collateral, and uncertain whether perfection will actually secure their rights to such collateral. As a result, creditors that might otherwise be inclined to provide funding to information age businesses are currently discouraged from doing so because of the added risks involved in complying with the relevant statutory schemes.

The federal statutory schemes governing intellectual property rights are the Copyright Act, the Patent Act, and the Lanham Act. These statutes all have a title-centered concern for the owner of intellectual property rights and the exact boundaries of that owner's rights. In effect, these statutory schemes are designed to work the way tract recording systems work in real estate. Their principle function is to establish title to intellectual property rights and to provide a recorded chronology of the transfers of ownership of these rights. Although security interests in intellectual property may be recorded as discretionary documents, they are ill fitted to these title-based schemes since they reflect only an encumbrance on, and not a transfer of ownership of, the intellectual property. Since the intended purpose of the federal schemes was to identify the title-holder of intellectual property rights, they are inadequately designed to accommodate mere encumbrances on those rights.

Article Nine of the UCC is a state statutory scheme that was designed to govern encumbrances. The purpose of Article Nine is to facilitate financing by creating a comprehensive scheme for the regulation of security interests and by providing creditors with an efficient and streamlined method of perfecting security interests. Creditors who comply with the perfection requirements of Article Nine are generally protected against subsequent third party claims. When conflicts involving multiple creditors having security interest in the same collateral arise, Article Nine lays out specific guidelines as to the priority enjoyed by each creditor.

Since Article Nine was designed to accommodate the financing of industrial-age assets, many of its provisions do not appropriately address the issues surrounding information-age financing. For example, under the old version of Article Nine, the proper place for filing depend on a preliminary classification of the collateral and its situs. Information age collateral exists in forms which are difficult to classify in industrial-age terms and which may change during the different stages of its development.

Preemption of federal law also creates difficulties when applying Article Nine to intellectual property. Article Nine recognizes the preemptive effect of federal law and is designed to give way to overlapping federal statutory schemes. It is unclear at the moment, however, to what extent the federal statutory schemes governing intellectual property overlap with provisions in Article Nine. Although the consensus is that Article Nine should be applied to security interests in intellectual property, there is disagreement as to how or when it should be applied. Courts which have addressed the issue have only confused it by coming to varied and

conflicting conclusions. The result of this legal complexity is that creditors making a good faith effort to comply with statutory perfection requirements risk complying with the inappropriate statutory scheme and losing their interest in the collateral—the very risk which secured financing is supposed to eliminate.

In their 1992 Preliminary Report on *Security Interests in Intellectual Property*, the ABA Task Force observed that: “The current state of the law governing security interests in intellectual property is unsatisfactory. There is uncertainty as to where and how to file, what constitutes notice of a security interest, who has priority, and what property is covered by a security interest. This area of the law is further complicated by the fact that both federal and state laws impact on these issues”.²

This Report proposes three model statutes that will help to clarify the uncertainty surrounding security interests in intellectual property collateral by creating a centralized or integrated registry for perfecting such collateral. The centralized and integrated registry would not supplant the existing substantive federal or state laws, but would rather compliment them by offering a central information forum that would be available to anyone seeking security interest information on intellectual property. Such a registry will retain the notice based filing system of Article Nine while also reducing the financial risk facing secured creditors by providing them with a central venue for perfection. Such a registry will allow practitioners, creditors and other interested parties to conduct a single, comprehensive search to uncover prior recorded interests and make a determination of an asset’s encumbered status.

A centralized or integrated registry will eliminate the confusion surrounding statutory perfection requirements and will assure creditors that compliance with these requirements will secure interests in intellectual property collateral. Reducing the risk faced by creditors will promote the financing and development of intellectual property and enable companies and individuals to extract the full value of their information-age assets.

² Task Force on Security Interests in Intellectual Property, Business Law Section, American Bar Association, Preliminary Report 1 (June 1, 1992). [Hereinafter referred to as Preliminary ABA Task Force Report]. As of March 1, 1999, the Task Force had drafted a piece of consolidated federal legislation entitled the “Federal Intellectual Property Security Act.”

II. MARKET TRANSACTIONS

A. *The Role of Intellectual Property in Market Transactions*

The increasing rate of new business formation in the entrepreneurial sector is testimony to systemic change in the United States economy. Employment and gross national product ("GNP") data reveal the systemic shift to an economy dominated by the innovative start-up. From 1954-1979, the share of GNP represented by the Fortune 500, the 500 largest companies in the United States, grew from 37% to 58%. The payrolls of these 500 largest US industrial corporations peaked in 1979 at 16 million jobs. Since 1979, Fortune 500 employment has exhibited a steady decline as employment decreased by over 25% or four million jobs. In 1996 the percentage of employment represented by the Fortune 500 was a scant 10%. From 1979 to 1995, the invisible entrepreneurial economy generated over 24 million new jobs as the number of new business creation increased 200%.³

For today's businesses, assets in the form of intellectual property are often more relevant and valuable than assets in the form of buildings and machinery. "For most companies, intellectual property today is the most important corporate asset Intellectual property has increased dramatically in importance for corporations over the last 20 years. In 1982, the hard assets of industrial companies were said to account for 62% of the companies market value. By 1992, tangibles made up 38% and intangibles 62% of their value. In 2000, intangible assets and intellectual property values are clearly the most important assets of most industrial companies given the increased intensity of competition, increased rapidity of technological growth and innovation, increased reliance on legal protection of right in intellectual property and increased enforcement of ownership rights, and increasingly sharp liability standards for infringement and misappropriation."⁴

These intellectual property assets are directly related to wealth generation and creating the next MOP (millionaire on paper). In the heartland of intellectual property creation, Silicon Valley at one point was

³ See W.J. Dennis Jr., *More than you think: an inclusive estimate of business entries*, Journal Of Business Venturing, 1997, 173-196; J. Freear, J.E. Sohl and W.E. Wetzel, *The informal venture capital market: milestones passed and the road ahead*, Entrepreneurship 2000, 1997, 47-70.

⁴ See Swiss Reinsurance Company, 2000, *The significance of intellectual property assets, risks and insurance*. Swiss Re Website.

minting 64 millionaires a day.⁵ The source of wealth for the top high net worth group in the United States has shifted to self-made first generation entrepreneurs with the growth of the entrepreneurial economy. In 1997 seventy-two percent, nearly three in four individuals, of the wealthiest Americans were self-made first generation entrepreneurs.

This transition from an industrial, goods based economy to an entrepreneurial, knowledge based economy is now firmly embedded in the fabric of the United States economy. As with any systemic change, which occurs within a relatively short time frame, this change is creating profound implications for entrepreneurs, business owners and investors as well as capital markets. Certain of these profound implications stem from the increased recognition of the true value of intellectual property and its relevance in this economy. The characterization of intellectual property as a significant business asset, leads entrepreneurs as well as established companies to seek methods to leverage the value of intellectual property in transactions.

The development and commercial exploitation of intellectual property occurs in a legal, social, political, and economic environment. This environment has been affected by past events, and is influenced by current attitudes, and by expectations of the future. In many industries, the speed of change of knowledge and innovation is accelerating, especially in the so-called “new economy” of electronic commerce. Paradoxically, although the new economy is knowledge-based, its speed of change is such that the value of that knowledge to its owner may be very short-lived.⁶ In some industries, product life cycles are shrinking from years to months. Intellectual property rights must be exploited increasingly rapidly if their owner is to reap a commercial return. Thus, the ability to exploit the value of intellectual property assets may depend upon raising adequate external financing in a timely manner. Any delay in such transactions may have deleterious consequences.

⁵ See E. Nieves, *In man-rich silicon valley, romance is full of glitches*, THE NEW YORK TIMES, Monday, April 10, 2000.

⁶ “For example, in a federal suit filed in Seattle [in 1999], Amazon.com accused rival Barnes & Noble.com Inc. of ‘willfully infringing’ on a patented ordering system that allows customers to buy things with a single mouse click. Barnes & Noble.com has called the suit ‘completely without merit.’ The Seattle court issued a preliminary injunction barring Barnes & Noble.com from using the system

Under fire for his company’s suit, Amazon chief executive Jeff Bezos has proposed a sharp reduction in the duration of Internet-related patent rights, which, like all other patents, are good for 20 years from application. Such a reduction would require Congressional or court action, as well as negotiation of new international intellectual-property pacts.” *U.S. Will Give Web Patents More Scrutiny*, Wall Street Journal, March 29, 2000.

In seeking to leverage the value of intellectual property assets, whether through debt or equity financing alternatives, economic behavior and decision making rests on a recognition that choices have to be made about how to use scarce resources in a manner that is efficient in its use, and effective in meeting the goals and objectives of the society of which the economic system is an important part. One of the key institutions in the economic system is the market, along with the government, the legal systems, households and firms. A market's function is to allocate scarce resources according to the strength of the demand for them, although the effects of market forces may be modified by the intervention of one or more of the other key institutions. Markets provide a mechanism that strikes a price for a good or service. In some markets, the information needed to achieve this end is relatively straight forward. In other markets, a more complex valuation process may be required of individual market participants, who may not have full access to all information. At either extreme, individuals make decisions based on these value estimates.

In deciding whether to lend money to exploit intellectual property rights, investors must be satisfied, among many other matters, that these rights in relation to the intellectual property will be protected. The economic decision to use scarce resources (capital) becomes easier when risk is reduced, creating greater efficiency for the investor or lender. Because the ability to commercially exploit intellectual property assets is likely to depend upon raising adequate capital, it is also likely to depend on the existence of lower risk and efficient markets for such capital. We propose that a centralized or integrated registry for security interests in intellectual property will have the direct effect of creating a new capital market for the entrepreneur by making more efficient the issuance of secured debt by traditional lenders; and will indirectly expand primary equity and secondary markets by creating more efficient access to information regarding the ownership of and encumbrances on the intellectual property assets seeking to be leveraged.

Currently the major, and often the only source of capital available for innovators and entrepreneurs to transform their ideas and intellectual property into viable commercial applications are private equity markets. [See Appendix 4.] As entrepreneurial ventures grow and mature they pass through various stages in the search for equity capital. Initially, seed financing provides relatively small amounts of equity capital to an entrepreneur/inventor to prove a concept and to qualify for start-up capital. Start-up financing is equity capital for companies completing product development and initial marketing. These companies may be in the process of organizing or they may already be in business for one year or less. Early-stage financing is generally considered to be equity capital for the expansion of a company that is producing and delivering products or services.

Although the company has made progress, it is generally less than five years old and may not yet be showing a profit. Later stage financing are funds provided for a major expansion of the company whose sales volume is increasing or for a venture expecting to go public within six months to a year.

As the entrepreneurial venture grows, so does the appetite for cash. Previous studies identified private investors, “angels”, as the major source of capital in the seed and start-up stage.⁷ This relatively invisible source is the oldest and largest segment of the U.S. venture capital industry. A typical angel deal is an early-stage round (seed or start-up) in the \$100 thousand to \$1 million range, raised from six or eight investors. In contrast to the angel population, institutional venture capital funds, the visible segment of the private equity market, invest primarily in later stage, and consequently larger, amounts, than their angel counterparts.⁸ A typical round of financing from a venture capital fund is a later stage deal in the \$8-10 million range. The private investor and the institutional venture capital market, while operating primarily in different stages, are complimentary in the sense that the informal private investor market now provides the seed and start-up capital that spawns new ventures. As the venture grows, it begins to outstrip the ability of individual investors to supply adequate equity capital. At this point, professional venture capital funds may take interest in the venture, particularly if the venture has demonstrated some success and has progressed beyond the risk-laden seed and start-up stages of its development towards sustainable growth. [See Appendix 4.]

Primary capital markets, such as the above described equity markets or the more traditional debt markets do not operate in isolation, but within an economic system. This system includes other markets, for example, secondary markets which provide a market for those debt or equity holders to sell their interest in securities, and to buy securities from other holders. As financing alternatives are examined by the entrepreneur who seeks to leverage the value of intellectual property assets, the relationship between primary and secondary markets must be examined.

⁷ See J. Freear, J. E. Sohl and W.E. Wetzel, *Angels: personal investors in the venture capital market*, ENTREPRENEURSHIP AND REGIONAL DEVELOPMENT, 1995, 85-94; R. J. Gaston and S.E. Bell, *The informal supply of capital*, Office of Economic Research, U.S. Small Business Administration, Washington, D.C. 1988; W.E. Wetzel Jr., *Angels and Informal Risk Capital*, SLOAN MANAGEMENT REVIEW, 1983, 23-34.

⁸ J.A. Timmons and W.D. Bygrave, *Venture Capital: reflections and projections*, ENTREPRENEURSHIP 2000, 1997; R. Meyer, et al, *The National Census of Early Stage Capital Financing*, 1995; J.A. Timmons and H.J. Sapienza, *Venture Capital: the decade ahead*, THE STATE OF THE ART ENTREPRENEURSHIP, 1992.

The relationship between primary and secondary markets plays a major role in the raising of capital. Suppliers of capital in primary markets, specifically potential debt and equity holders, will tend to be more willing to make the initial investment in the business in a primary market,⁹ if the potential suppliers of capital know that they will be able to liquidate their investment, in a timely and relatively low cost manner, on a secondary market through asset securitization (such as the NYSE or NASDAQ). [See Appendix 5.] If they have no such option, they might be inhibited from making the investment. In the absence of a secondary market, they might be obliged to hold their investment for the long term, with little no prospect of being able to liquidate it. Or, they might be able to liquidate only at a high transaction cost incurred in finding a willing buyer. These inhibiting factors, in turn, may make the investment less liquid, less attractive, and hence less valuable. The existence of a secondary market with efficiency attributes may encourage, therefore, the raising of debt and equity capital on the primary markets, and help support the growth of those firms seeking additional funding, for example, innovators and entrepreneurs. The existence of a secondary market relies on one's ability to retain ownership of the underlying collateral while leveraging the value of, or future income streams from, that collateral to raise large amounts of capital. In theory, securitization of intellectual property assets is not different from a typical securitization involving credit card receivables, mortgages and auto loans.¹⁰

Thus, regardless of whether the entrepreneur attempts to raise needed capital through traditional debt markets, primary equity markets or secondary markets, the examination and tracking of ownership of intellectual property rights is paramount to the lenders or investors' ability to determine if that particular investment or loan is an efficient use of capital. One way to expand both debt and equity markets and consequently create more efficient and less expensive access to capital for the inventor and entrepreneur is to clarify the uncertainty surrounding the creation and tracking of security interests in intellectual property assets. This premise is clarified when current market imperfections and inefficiencies are examined in greater detail.

⁹ There are many primary markets in addition to the NYSE (which can function as both a primary and secondary market), some of which will be discussed later.

¹⁰ See Nicole Chu, *Bowie Bonds: A Key to Unlocking the Wealth of Intellectual Property*, 21 HASTINGS COMM. & ENT. L.J. 469, Winter, 1999.

B. Market Imperfections and Inefficiencies

For the established firm, financial markets currently supply a complete variety of financing instruments, with these markets being relatively accessible the owner/manager is left to decide the optimum mix of a financial structure based on the cost of capital, stemming from the level of risk in the transaction. Since buildings and machinery, as opposed to intellectual property, are the major assets of the established firm, asset based loans can be transacted efficiently and the cost of capital is reduced. However, for the high growth entrepreneurial firm and the early stage innovator/inventor, this supply assumption may not hold, causing systematic market mismatches at particular stages of development of the fast growth firm.¹¹ These systematic market mismatches can be considered market imperfections. Most notably in the informal venture capital market, such market imperfections are well documented.¹² Two market imperfections, creating risk for the investor in the intellectual property transaction are: 1) incomplete information and 2) inaccurate values of intellectual property assets. Solving for these market imperfections is one way to assist both the entrepreneurial high growth firm and the early stage innovator in their efforts to exploit the value of their intellectual property.

The market imperfection of incomplete information exists in the early stage market and is faced by both the entrepreneur/inventor and the investor. One issue is the lack of historical information. Information on the value of the opportunity is incomplete in the sense that there is no historical record or financial information on which to base a business valuation. Given the inherent risk in the early stage of a venture's development and growth, detailed analysis may still not fill this gap, especially acute since future markets and consumer behavior are difficult to predict. While the existence of certain intellectual property rights mitigates some of this risk, the commercialization of that intellectual property is a major factor in determining market risk and investors expected rates of return.

Another information issue is that critical information is held asymmetrically by the investor and the entrepreneur. Detailed technical information (especially acute for high tech ventures), and the value and merit of the technological advancement, is usually best understood by the

¹¹ See D.J. Brophy, *Financing the growth of entrepreneurial firms*, ENTREPRENEURSHIP 2000, 1997, p. 5-27.

¹² See J. Freear, J. E. Sohl and W. E. Wetzel, Jr., *The private investor market for venture capital*, THE FINANCIER, 1994, p. 7-15; R.T. Harrison and C. M. Mason, *Financing for the growing business: the role of informal investment*, NATIONAL WESTMINSTER QUARTERLY REVIEW, 1993, 17-29; H. Landstrom, *Informal risk capital in Sweden and some international comparisons*, JOURNAL OF BUSINESS FINANCING, 1993, p. 525-540.

entrepreneur. To further complicate matters, the presence of any existing liens or encumbrances on intellectual property rights is currently within the sole purview of the entrepreneur. Such information is critical to the investor in the decision-making process. Thus, to make an informed investment decision the investor must in large part rely on information from the very source, the entrepreneur, who directly benefits from the investment. In contrast, the investor is in possession of market and financing information based on experience from past investments. The entrepreneur lacks this information and is unable to attain it within the confines of the current transaction. Additionally, only the entrepreneur holds information regarding his or her skills. The investor may not have knowledge about the entrepreneur's abilities, managerial skills and commitment. This information is, however, vital to the investor in the decision-making process.

The market imperfection of inaccurate values of intellectual property assets stems from the difficulty in assessing such value without detailed technological information. To divulge such sensitive information the entrepreneur risks the appropriation of this information by the investor or other entrepreneurs. The time to secure patent and intellectual property information, and the cost to secure that information, also become critical issues in the new economy. Delays in acquiring information translate into, at the minimum, increases in transaction costs (in terms of time and money), or, in the most severe case, the failure to seize an opportunity or loss of the first mover advantage due to rapid developments and competition in the fast paced new economy.

To deal with these information problems, the private equity markets have evolved into adopting a strategy of financing stages, with information becoming increasingly available as the stage of financing progresses. Unfortunately, while correcting some information deficiencies, the staging of financing creates some of its own issues. Specifically, staging requires information to be collected and assimilated at each individual stage. The supply of capital is stage dependent, and is derived from different sources and types of capital providers. As a result, market imperfections such as valuation, the determination of encumbrances on intellectual property, and the related transaction and information issues arise at each individual financing stage. [See Appendix 6.]

Market imperfections lead to market inefficiencies. In an efficient market there are fully informed buyers and sellers, an open and timely flow of reliable information and minimal transaction costs. In our current system, where new ventures are spawned from the commercialization of intellectual

property and capital is provided by the private equity markets, the capital markets are anything but efficient.¹³

At least two inefficiencies in the equity financing market for entrepreneurial ventures have been identified.¹⁴ These two critical inefficiencies, stemming from market imperfections, are the “capital gap” and the “information gap.” The “capital gap” is the gap between the needs of early stage ventures and the ability of investors to supply this early stage capital. The “information gap” is the lack of reliable information available to the investor. In the informal venture capital market, with the suppliers of capital seeking a degree of anonymity consistent with the need to maintain reasonable deal flow, and information on intellectual property equally difficult to secure in a timely manner, information flows very inefficiently. If one could solve for the “information gap,” the cost of capital to inventors and entrepreneurs would arguably be reduced through lower transaction costs to venture capitalists and lenders. If one could solve for the “capital gap,” a new capital market would arguably be created through the funding of early stage ventures by traditional lending institutions.¹⁵

In the lightning speed of the new economy, where opportunities and market niche can be lost in a short period of time, efficient financing processes are vital to the survival of commercial ventures. Currently, the imperfect and inefficient financing processes involving intellectual property assets are time-consuming and cumbersome. This situation hinders the growth of commercial ventures with intellectual property assets. Given the significant value of intellectual property assets and their critical role in business transactions, the creation of a structurally certain system not only for the creation of and title to intellectual property rights, but also for secured transactions encumbering intellectual property rights, is paramount to the continued vibrancy and growth of the debt and equity markets which drive the expansion of our knowledge based economy.

Inventors, entrepreneurs and investors alike would benefit by this elimination or reduction of market imperfections and inefficiencies in the equity and debt financing markets for entrepreneurial ventures. The ability of

¹³ Despite these inefficiencies, ventures based on intellectual property assets have been, and promise to remain, at the core of the recent high-growth economy in the United States.

¹⁴ See Obermayer, J.H., *The Capital Crunch: Small High-Technology and Equity Shortages* (Cambridge, MA: Research and Planning, Inc. 1983).

¹⁵ Traditional financing options involving intellectual property (without granting an equity position) include the outright sale or assignment of the asset to a third party who will value it at its best use, a license to use the intellectual property granted to a third party who can efficiently exploit the value of the property at its best use or a joint venture with others who are already able to efficiently exploit the best use value of the intellectual property. See THOMAS M. WARD, INTELLECTUAL PROPERTY IN COMMERCE § 2:1 (2000).

the entrepreneur, inventor or business person to transact business and to extract value from intellectual property would be enhanced. To begin to solve for market imperfections and inefficiencies, which negatively impact the entrepreneurs access to capital through debt and equity markets, one must examine in detail the complex legal and regulatory structures surrounding intellectual property rights. It is the uncertainty created by this legal and regulatory structure which lends to the very market imperfections and inefficiencies currently minimizing the ability to leverage the value of intellectual property assets and consequently stunting the economic growth of inventors and entrepreneurs.

III. OVERVIEW OF THE LEGAL SYSTEMS AFFECTING INTELLECTUAL PROPERTY AS COLLATERAL

A. The Federal Title System

Intellectual property can be broadly defined as any product of the mind in which one can assert some "ownership" rights. Although significant types of intellectual property are created and defined under state tort or property law, and can include such diverse areas as the right of publicity or trade secrets, the most valuable forms are patents, copyrights and trademarks, which are defined and protected by their own separate federal statutory schemes. The principal federal schemes protecting intellectual property are the Copyright Act, the Patent Act, and the Lanham Trademark Act.

While the federal intellectual property statutes differ from one another in many ways, they all share a common, title-centered concern for the owner and are designed to delineate the exact boundaries of that owner's rights. Conceptually, these systems are designed to work like tract recording works for real estate.¹⁶ The principal function of "recording" such rights at the federal level is to establish "title" to intellectual property rights (namely, the carefully defined exclusive rights) and to provide a recorded chronology of the ownership and transfer of those rights. These federal recordings may be searched by assignor or assignee name as part of the ownership tracking.

¹⁶ THOMAS M. WARD, *INTELLECTUAL PROPERTY IN COMMERCE* § 2:4 (2000); Weinberg & Woodward, *Easing Transfer and Security Interest Transactions in Intellectual Property: An Agenda for Reform*, 79 KY. L.J. 61, 75 (1991).

1. Copyrights

A copyright protects the creator of original works of authorship. A copyright owner has the right to exclude others from doing any of the following five activities in connection with the copyrighted work: (1) reproduction; (2) adaptation; (3) distribution in public; (4) performance in public; or (5) display in public.¹⁷ These legal rights of an author, artist, composer or other creator of intellectual property to control the use of his or her work by others may be transferred and owned separately. In contrast to a patent, a copyright comes into existence as soon as the creator fixes the work in a "tangible medium of expression." No registration is required to create legal rights in the property, although there is a system of registration available through the Copyright Office. Like patents, copyrights are now exclusively governed by federal statute.¹⁸ Unlike Patents, independent "creation" will not infringe upon another's copyright, even if the creations are identical. Copying, or the legal equivalent of copying, is required. Because not all copyrights are registered, the identification and tracking of copyrights can be much more difficult than with patents.

2. Patents

Patents generally protect the novel and nonobvious functional aspects of useful products or processes. A patent is a grant by the federal government to an inventor that gives the inventor the right to exclude others from making, using or selling the invention for 20 years. It does not matter if a subsequent user of the patented product or process independently creates the patented product or process, or is totally unaware of the prior patent. A patent holder is always able to stop a subsequent "inventor" from using the invention.

Patents are solely within the power of the Federal government.¹⁹ The U.S. Patent and Trademark Office ("USPTO") has exclusive authority to prevent others from making, using or selling the patented invention for a specified amount of time throughout the United States.²⁰ There is no state

¹⁷ These activities are listed in the Copyright Act. 17 U.S.C. §106.

¹⁸ 17 U.S.C. §§101-1101(1994) as amended by the Digital Millennium Copyright Act, Pub.L.No. 105-304, 122 Stat. 2860(1998).

¹⁹ 36 U.S.C. §1, *et seq.* The Federal government's power over patents (and copyrights, but not trademarks) is derived from the U.S. Constitution. Art. 1, Sec. 8 Cl. 8.

²⁰ See, Dickerson, *Symposium: From Jeans to Genes: The Evolving Nature of Property of the Estate*, 15 BANKR. DEV. J. 285 (Spring 1999).

patent system. It is a relatively straightforward process to identify and track a patent since it cannot exist until the Federal government issues the certificate and each patent is duly numbered. A patent owner may assign the entire patent right or any lesser interest to another party, and written assignments must be recorded with the USPTO.²¹

3. Trademarks: The Lanham Act

Although federally granted trademarks are the responsibility of the same federal agency charged with supervising patents, they are a very different form of property. For the purpose of this report, they differ from patents in three important ways: First, trademark protection is fundamentally a state common law right, which is only enhanced and protected by federal registration. Second, trademarks cannot stand alone as personal property. Finally, the recording provision for federally registered marks reflects these distinctive aspects in its very singular and narrow "assignments" scope.

Trademark rights arise under state law from the use of business names, images, sounds, and devices in association with the source and quality standard of a product or service of the enterprise. The existence of a mark depends upon customer identification of it with a particular source. Even the owner of the mark may not be able to control its creation. Although federal law allows for the federal registration of trademarks, and such registration elevates the degree of protection afforded an owner of a mark, federal law does not create separate exclusive property in the trademark in the same sense that it does for patents, copyrights and mask works.²²

Their state law origins are not the only thing that sets trademarks apart as "property." As the Federal Circuit has said: "Unlike patents or copyrights, trademarks are not separate property rights. They are integral and inseparable elements of the goodwill of the business or services to which they pertain."²³ Whereas copyrights and patents can stand on their own title,

²¹ 35 U.S.C. §261 (1994).

²² The Lanham Act provides that "[t]he owner of a trademark used in commerce may apply to register his or her trademark under this chapter." 15 U.S.C. § 1051(a) (1994). The Lanham Act permits the potential user of a mark to file an intent-to-use application covering a mark not presently in use. *Id.* § 1051(b). However, no registration can issue on an intent-to-use application unless the mark is actually used in commerce and its use is verified in a filed statement to that effect. 15 U.S.C. § 1051(d) (1994).

²³ *Visa, U.S.A., Inc. v. Birmingham Trust Nat'l Bank*, 696 F.2d 1371, 1375 (Fed. Cir. 1982).

trademarks cannot.²⁴ The dependent relationship between marks and other “good will” assets of the underlying user affects the usefulness of marks as a commercial asset. For example, while some security interests can be taken in a trademark standing alone (although not a recommended practice),²⁵ no effective disposition of trademark collateral at foreclosure is possible without the transfer of the debtor’s goodwill that is associated with the name or mark.²⁶

The property characteristics of a license or other contractual right to use a trademark are complicated by the definition of the underlying right as a designation of source. The owner/licensor of a mark must maintain control over the nature and quality of the product for which the name or mark designates origin.²⁷ Licensing without the necessary licensor control can cause loss of the trademark. It was concern over a post-contractual obligation to police the mark that caused Congress to omit trademarks from the Bankruptcy Code’s definition of “intellectual property.” The definition is critical to the scope of provisions added in 1988 that, in effect, allow licensees to retain the right to use licensed “intellectual property” after the licensor has rejected most of its related duties under the licensing contract.²⁸

Finally, the dependent relationship between marks and other assets of the underlying user suggests that separate mortgage rights generally taken by a lender or other financier, not an underlying user, are not included in the federal statute dealing with the transfer of registered marks and pending applications.

²⁴ *United Drug Co. v. Theodore Rectanus Co.*, 248 U.S. 90,97 (1918)(“There is no such thing as property in a trademark except as a right appurtenant to an established business or trade in connection with which the mark is employed”); *Visa, U.S.A., Inc. v. Birmingham Trust Nat’l Bank*, 696 F.2d 1371 at 1375 (“[A] mark may be transferred only in connection with the transfer of the goodwill of which it is part. A naked transfer of the mark also known as a transfer in-gross is invalid.”); *Glamorene Products Co. v. The Procter & Gamble Co.*, 538 F.2d 894 (C.C.P.A. 1976). But see NAFTA Treaty, *INFRA* note 162 at art. 1708.

²⁵ The first paragraph of the Official Comment to current Article Nine section 9-106 mentions trademarks as personal property within the category of general intangibles. See U.C.C. § 9-106, cmt. ¶1. See also UCC [Revised] § 9-102(a)(42) & cmt. 5(d).

²⁶ *Sugar Busters LLC v. Brennan*, 177 F.3d 258, 265 (5th Cir. 1999)(“[A] trademark cannot be sold or assigned apart from the goodwill it symbolizes.”). See also *supra* note 24.

²⁷ 15 U.S.C. § 1055 and § 1127 (1994).

²⁸ 11 U.S.C. § 101(35A)(B) & (C) (1994). See also S. REP. NO. 100-505 at 6, 1988 U.S.C.C.A.N. at 3204.

B. The State Encumbrance System

The state law governing security interests in personal property is Article Nine of the Uniform Commercial Code ("UCC"). A security interest is the contingent right to an asset (should the borrower default) created by a security agreement. The security agreement allows a lender or creditor to take or transfer ownership of the collateral in the event of default by the borrower. As conceptualized within the legal framework of Article Nine, the "security interest" is an encumbrance and divorced from "title."

In 1998, the Uniform [Model] Version of Article Nine was revised. This report will refer to the 1998 revised text as "Revised Article Nine." As of March 1, 2001, thirty-four states have adopted Revised Article Nine. Both Article Nine and Revised Article Nine govern most types of security agreements covering personal property that are both consensual and commercial. Revised Article Nine's provisions are intended to "place virtually all filings in a single, statewide office, facilitate electronic filing, foster nationwide utilization of well-designed user-friendly uniform paper forms, and make new document filing more efficient, transparent, and uniform."²⁹

Substantively, the Revisions expand the scope of Article Nine's application, clarify choice of law rules governing perfection and priority, adopt media neutral filing approaches, and more precisely set forth provisions relating to default and enforcement.

Both the current and Revised versions of Article Nine use broad language to describe the transactions covered.³⁰ Current section 9-102(1) brings within the Article "any transaction (regardless of form) which is intended to create a security interest in personal property"³¹ A "security interest" includes "any interest in personal property or fixtures which secures

²⁹ See Harry Sigman, *Twenty Questions About Filing Under Revised Article 9: The Rules of the Game Under New Part 5*, 74 CHI-KENT L. REV. 861 (1999).

³⁰ UCC § 9-102(1). *Accord* U.C.C. [Revised] § 9-109(a) & cmt. 2. The first paragraph of the first Official Comment in the current Article proclaims that:

This Article sets out a comprehensive scheme for the regulation of security interests in personal property and fixtures. It supersedes prior legislation dealing with such security devices as chattel mortgages, conditional sales, trust receipts, factor's liens and assignments of accounts receivable UCC§ 9-101, cmt. 1; U.C.C. § 9-102, cmt. - "Purposes."

³¹ UCC § 9-102(1). In July, 1998, the Drafting Committee working on Revised Article Nine moved the "scope" language to section § 9-109. Draft UCC [Revised] § 9-109 (Draft For Approval, July 24-31, 1998). Revised section 9-109 contains expanded language to include the *sale* of a "payment intangible" within the scope of Article Nine. UCC [Revised] § 9-109 (a)(3).

payment or performance of an obligation," as well as any outright sale of an account or chattel paper that has a financing context.³²

Any lender or financing assignor that desires to create a security interest in intellectual property, can currently produce an agreement that fits just as squarely into these definitions as if the collateral were tangible inventory or equipment. The issue with such agreements is that intangible intellectual property rights can be divided up under an almost infinite variety of contractual arrangements. Sometimes a secured transaction hides within the form of another common contractual arrangement, such as an assignment or license. The parties to the security agreement may fail to appreciate the nature of the substantive rights created by their deal. For example, an exclusive licensor of a patent or trademark that retains only naked legal title to the patent for the purpose of securing the licensee's payment or performance has essentially transferred ownership of the intellectual property, and the retained interest is really only a security interest.³³ Even if the terms of such a license provide that the licensor may terminate "the license" on an event of default, the licensee, as the true equitable title holder, will be entitled to assert the rights of a "debtor" under Part Five of Article Nine.³⁴ Consequently it is necessary to discuss the classification of collateral under Article Nine.

³² UCC §§ 1-201(37) & 9-102(1)(b). *Accord* UCC [Revised] § 1-201(37)& 9-109(a)(3)(Revised Article Nine also brings in the sale of payment intangibles and promissory notes). *See, e.g., In re Vigil Bros. Construction, Inc.*, 193 B.R. 513, 516 (9th Cir. B.A.P. 1996)(any assignment of an account falls under the purview of Article Nine, regardless of whether the parties intend to create a secured transaction). The included absolute transfers must be within the context of commercial financing, however. Current section 9-104(f) excludes from Article Nine coverage: (1.) assignments of accounts or chattel paper that arise out of a sale of the generating business, (2.) assignments for collection only, (3.) assignments to performing assignees, and (4.) assignments in full or partial satisfaction of prior debts. UCC § 9-104(f). *Accord* UCC [Revised] § 9-109(d)(4),(5),(6)&(7). *See also* UCC § 9-302(1)(e) and UCC [Revised] § 9-309(2)(automatic perfection for "insignificant" assignments).

³³ THOMAS M. WARD, *INTELLECTUAL PROPERTY IN COMMERCE* §§ 3:3 AND 3.4 (2000); Bramson, *Intellectual Property as Collateral - Patents, Trade Secrets, Trademarks and Copyrights*, 36 BUS. LAW 1567, 1588 (1981). (Exclusive licensor of a patent that retains only legal title has, in effect, assigned the patent to the "licensee").

³⁴ *Warnaco, Inc. v. Farkas*, 872 F.2d 539, 543 (2d Cir. 1989)("A license of trademarks is for present purposes functionally indistinguishable from a lease of equipment where title is to pass for nominal consideration upon satisfaction of the debt incurred as part of a purchase of the trademarks or equipment. The trademarks were therefore collateral as a matter of law.")(emphasis added). The federal classifications for intellectual property are substance-driven as well. *See, e.g., Raber v. Pittway*, 23 U.S.P.Q.2d 1313 (N.D. Cal. 1992); *Bell Intercontinental Corp. v. U.S.*, 152 U.S.P.Q. 182, 184 (Ct. Cl. 1966).

1. Classification of Collateral

a) Intellectual Property Generally

Article Nine applies specifically to secured transactions in "personal property."³⁵ While the term "personal property" is not expressly defined in either the current or Revised versions of the Article, current section 9-102(2) contains a list of examples. The list includes a reference to "general intangibles."³⁶ Every form of personal property not otherwise defined and labeled under Article Nine falls under the default definition of a "general intangible."³⁷ The definition covers "*any* personal property (including things in action) *other than* goods, accounts, chattel paper, documents, instruments, and money."³⁸ The Comment to current section 9-106 confirms that the term "general intangibles" was intended to have a broad scope. The Comment to Article Nine explains that "[t]he term 'general intangibles' includes miscellaneous types of contractual rights and other personal property which are used *or may become customarily used* as commercial security."³⁹ The Comment also provides a nonexclusive list of general intangibles. The items include "goodwill, literary rights and rights to performance," as well as "copyrights, trademarks, and patents, except to the extent that they may be

³⁵ UCC § 9-102(1)(a).

³⁶ *Id.*

³⁷ UCC § 9-106. *Accord* U.C.C. [Revised] § 9-102(a)(42). The definition of a general intangible under the revisions does not include a "commercial tort claim." "Commercial tort claims" include claims for infringement of intellectual property rights. UCC [Revised] § 9-102(a)(13). These claims are a separate form of collateral under the Revisions but have no status as original collateral under the current Article Nine language. Under current Article Nine, tort claims are clearly things in action under section 9-106, but are excluded altogether under the language in section 9-104(k). UCC § 9-104(k). Revised Article Nine, on the other hand, recognizes that a claim for infringement has status as collateral apart from the underlying right infringed, special care must be taken with original "commercial tort claim" collateral. Revised section 9-108(e)(1) requires that these claims be specifically described in the security agreement. An indication merely by category or by type is inadequate. UCC [Revised] § 9-108(e)(1). Revised section 9-204(b)(2) also provides that a security interest in a commercial tort claim cannot attach under an after-acquired property clause. UCC [Revised] § 9-204(b)(2). See THOMAS M. WARD, *INTELLECTUAL PROPERTY IN COMMERCE* §§ 1:9 and 1:10 (2000).

³⁸ UCC § 9-106 (emphasis added) *Accord* UCC [Revised] § 9-102(a)(42).

³⁹ UCC § 9-106, cmt. (emphasis added).

excluded under section 9-104(a) because federal law or federal regulations cover them."⁴⁰

Further, "general intangibles" as defined was intended to include newly created forms of intangible personal property when they become significant as commercial assets.⁴¹ The Comment to current section 9-101 refers to "other personal property that may become customarily used as commercial security."⁴² This language suggests that the "general intangibles" category was designed to accommodate both existing and future forms of intellectual property. New forms of intangible property created since the date of the Comment continue to fit comfortably within the category of "general intangibles." One example would be, the special form of intellectual property protection provided for "mask works"⁴³ under the 1984 Semiconductor Chip Protection Act ("SCPA").⁴⁴ The property created by the SCPA fits within the section 9-106 definition of a general intangible, except to the extent that it may be excluded under the preemption doctrine recognized in current section 9-104(a) or the filing deferral doctrine recognized in current section 9-302(3)(a). State law definitions of intellectual property have also been expanded to include property rights such as publicity and data rights that did not exist when the current version of Article Nine was drafted.⁴⁵ The issue remains, however, whether certain intellectual

⁴⁰ *Id.* See UCC § 9-104(a); UCC [Revised] § 9-311(a)(1).

⁴¹ This open-ended approach to intangible property is also reflected generally in the Official Comment to section 9-101: "The Article's flexibility and simplified formalities should make it possible for new forms of secured financing, as they develop, to fit comfortably under its provisions, thus avoiding the necessity, so apparent in recent years, of year by year passing new statutes and tinkering with the old ones to allow legitimate business transactions to go forward." UCC § 9-101, cmt.

⁴² UCC § 9-106 cmt.

⁴³ "Mask work" refers to the set of templates or "masks" that together make up the design of a semiconductor chip. The chip manufacturer uses these masks in a photographic depositing and etching process to build up the three-dimensional structure of the chip. Metallic layers, insulating layers and semiconductor layers are stacked on a silicon wafer. The SCPA does not protect the chip's functional capabilities, however. The Act only prohibits the copying of the physical topography or design layout of a particular chip. To date, the Act has not significantly affected the industry. Michael A. Ladra & James C. Otteson, *Chip Protection Act May Miss the Mark*, NAT. LAW J., Jan. 24, 1994, at S8. Only two reported cases have applied the SCPA since its enactment. *Booktree Corp. v. Advanced Micro Devices, Inc.*, 977 F.2d 1555 (Fed. Cir. 1992); *Anadigics, Inc. v. Raytheon Co.*, 903 F. Supp. 316 (S.D.N.Y. 1995).

⁴⁴ 17 U.S.C. §§ 901-914 (1988).

⁴⁵ A "publicity" right, as a person becomes famous, as recognized under the law in some states, has many characteristics of intangible property. It may survive the death of the person whose persona is protected and it can be transferred. *Haelan Laboratories, Inc. v.*

property assets fall within the definition of “general intangibles” and are thus subject to Article Nine. For example, is the license of intellectual property in the hands of a licensee/debtor a “general intangible” that can be used as collateral under Article Nine? The answer appears to be “yes” regardless of whether the license is exclusive or nonexclusive and nonassignable.⁴⁶ [See Appendix 7 and Appendix 8.]

b) Receivables

The various and varied *rights to payment* that arise when an interest in intellectual property is transferred or licensed is a separate form of collateral capable of separate ownership.⁴⁷ Except perhaps for the income

Topps Chewing Gum, Inc., 202 F.2d 866, 868 (2d Cir.), *cert denied*, 346 U.S. 816 (1953)(assignment recognized); Douglas v. Hustler Magazine, Inc., 769 F.2d 1128, 1138 (7th Cir. 1985), *cert. denied*, 475 U.S. 1094 (1986)(license recognized). The Ninth Circuit has held that the person who develops the engineering and test data necessary to obtain a Supplemental Type Certificate from the Federal Aviation Administration has a “property interest” in the data and in the certificate which will be protected against appropriation and improper use under California law. G.S. Rasmussen & Assoc. v. Kalitta Flying Service, 958 F.2d 896 (9th Cir. 1992).

⁴⁶ Even if the licensee takes no right in the underlying intellectual property under the license, the licensee is still entitled to enforce the licensor’s promise not to sue for infringement. This can and should be viewed as a contract right enforceable by action. As such, it would seem to be within the section 9-106 reference to “things in action.” UCC § 9-106. *Accord* UCC [Revised] § 9-102(a)(42).

⁴⁷ A security agreement that describes covered collateral as “rights to the payment of money however evidenced or arising including...each future account . . . general intangible...and document” effectively describes income streams defined as either accounts or general intangibles but does not reach post-petition proceeds from the *assignment* of a general intangible in the form of a trademark license. The right to payment from an intangible asset is not the same as the asset itself although both may be section 9-106 “general intangibles.” The security agreement description above did not reach the trademark license and therefore the money due on the debtor’s post-petition assignment of the trademark license could not be saved to the secured party as “proceeds” of pre-petition collateral under section 552(b) of the Bankruptcy Code. *In re Specialty Foods of Pittsburgh, Inc.*, 98 B.R. 734, 736-37 (Bankr. W.D. Pa. 1989). *See* 11 U.S.C. § 552(b) (1994). Although these “rights to payment” are either separate accounts or separate general intangibles, they are in a sense dependent on the underlying licensed right. Unless the secured party has a security interest in the underlying right, the debtor could interrupt or extinguish the income stream by assigning the underlying right. “Royalties to accrue pass with the assignment of the patent to the assignee” E. Lipscomb, 6 WALKER ON PATENTS § 20:47 at 161-62 (1986). The right to receive royalties can be separated from the underlying right by an express reservation, however. *Crom v. Cement Gun Co.*, 46 F. Supp. 403, 405-06 (D. Del. 1942)(“Where an assignment conveys all the assignor’s right, title and interest, if the right to receive royalties is to be

generated by the sale or licensing of software packages to some ultimate users, these rights to payment also fall within the residual category of "general intangibles" under current Article Nine language.⁴⁸ In contrast, all rights to payment under the terms of an assignment or license of intellectual property are "accounts" under Revised Article Nine.⁴⁹ *In Re SSE International Corp.* illustrates the way the residual definition of a general intangible captures rights to payment that arise when a general intangible is sold (assigned) or licensed. [See Appendix 9.]

c) Accounts

The definition of an "account" in Revised Article Nine § 9-102(a)(2) has been expanded from its former "goods and services" base to include a right to payment "for property that has been, or is to be, sold, leased, *licensed*, assigned, or otherwise disposed of . . .".⁵⁰ The word "property" in Revised section 9-102(a)(2) is not defined, but "personal property" has always included intangible property. A "right to payment" for intangible property sold or licensed would include most royalties and other income streams from intellectual property. As is the case under current language, the Revision definition of a "general intangible" excludes anything defined as an "account." An income stream from a license of intellectual property seems therefore to be an "account" and not a "general intangible" under the Revisions.⁵¹ Furthermore, these rights to payment cannot be "payment

severed from the beneficial ownership of the patent and remain in the assignor, there must be an express reservation or some agreement to that effect. I do not think that the mere retention of the "license" [by which term the parties to this case apparently mean the paper evidencing the right to receive royalties] is sufficient to make the severance . . ."). *See Broadcast Music, Inc. v. Hirsch*, 104 F.3d 1163, 1166 (9th Cir. 1997) ("Assignments of interests in royalties have no relationship to the existence, scope, duration or identification of a copyright, nor to "rights under a copyright.").

⁴⁸ UCC § 9-106, cmt. To the extent that the sale of some software is treated as a sale of goods under the current language of Article Nine, the generated receivable will be considered an account under section 9-106. UCC § 9-106. Note that "software" is expressly classified as a general intangible under the language of the Article Nine Revisions. UCC [Revised] § 9-102(a)(42).

⁴⁹ UCC [Revised] § 9-102(a)(2).

⁵⁰ UCC [Revised] § 9-102(a)(2) (emphasis added).

⁵¹ Compare UCC § 9-106 with UCC [Revised] § 9-102(a)(42). *See* UCC [Revised] § 9-102(a)(2).

intangibles" because "payment intangibles" are made a subcategory of "general intangibles" under the new definitions."⁵²

d) Proceeds

Tort claims, including infringement actions, are excluded from current Article Nine under section 9-104(k).⁵³ Revised Article Nine also excludes tort claims but creates an express "proceeds" exception for such claims, up to the value of the underlying intellectual property collateral infringed, as well as a separate exception from the general exclusion for "commercial tort claims."⁵⁴ Commercial tort claims are defined broadly to include all business-related tort claims that do not involve personal injury or death.⁵⁵ This exception from the "tort claims" exclusion means that infringement claims are potentially *original* collateral under Revised Article

⁵² UCC § 9-102(a)(61). UCC § 9-102(1)(a)&(b). See, e.g., *In re Vigil Bros. Construction, Inc.*, 193 B.R. 513, 516 (9th Cir. B.A.P. 1996)(any assignment of an account falls under the purview of Article Nine, regardless of whether the parties intend to create a secured transaction). In July, 1998, the Drafting Committee working on Revised Article Nine moved the "scope" language to section § 9-109. Draft UCC [Revised] § 9-109 (Draft For Approval, July 24-31, 1998). Revised section 9-109 contains expanded language. The new section includes the *sale* of a "payment intangible" within the scope of Article Nine. UCC [Revised] § 9-109 (a)(3). A "payment intangible" is defined as a "general intangible under which the account debtor's principle obligation is to pay money." UCC [Revised] § 9-102(a)(61). However, a "payment intangible" *does not* include the *sale or assignment* of an income stream from the licensing of intellectual property because such an income stream is an "account" under the expanded definition of that term in Revised section 9-102(a)(2). UCC [Revised] § 9-102(a)(2). Any right to payment that is an "account" is excluded from the definition of a "general intangible." UCC [Revised] § 9-102(a)(42). If the income stream from the licensing of intellectual property cannot be a "general intangible," it cannot fall within the subcategory of a "payment intangible" either. UCC [Revised] § 9-102(a)(61). As an "account," however, the sale, assignment or other outright transfer of such an income stream will be deemed to create a security interests irrespective of the intent of the parties. UCC [Revised] § 9-102(a)(2) & [Revised] § 9-109(a)(3).

⁵³ UCC § 9-104(k)& cmt. 8. *Carbice Corp. v. American Patents Dev. Corp.*, 283 U.S. 27, 33 (1931). See D. CHISUM & M. JACOBS, UNDERSTANDING INTELLECTUAL PROPERTY LAW § § 5F[1][a] (1992). When the section excludes property from Article Nine that exclusion applies to proceeds as well, except when the language of the exclusion provides otherwise. See, e.g., U.C.C. § 9-104(g)&(l).

⁵⁴ UCC [Revised] § 9-109(d)(12).

⁵⁵ UCC [Revised] § 9-102(a)(13).

Nine.⁵⁶ When infringement claims are claimed apart from underlying intellectual property collateral, however, they require special treatment. Revised section 9-108(e)(1) requires that these claims be specifically described in the security agreement. An indication merely by category or by type is inadequate.⁵⁷ Furthermore, Revised section 9-204(b)(2) also provides that a security interest in a commercial tort claim cannot attach under an after-acquired property clause.⁵⁸ Commercial tort claims raise unique issues for secured creditors. [See Appendix 10.]

2. UCC Article Nine: Attachment

a) Attachment as Predicate for Perfection

"Attachment" is the concept used in Article Nine to describe the incidents of the creation of a security interest in property of a *debtor*⁵⁹ in favor of a *secured party*.⁶⁰ To protect a security interest in a particular type

⁵⁶ "Commercial tort claims" are excluded from the residual category of general intangibles, however. UCC [Revised] § 9-102(a)(42). Note that infringement claims should pass as "proceeds" when the secured party holds the debtor's underlying intellectual property right as original collateral. UCC [Revised] § 9-102(a)(64)(D). However, some tort claims that are based in federal intellectual property statutes, can arise separately from the intellectual property *res* created by the statute. For example, a section 43(a) action for unfair competition, not tied to the protection of separately recognized trademark property would only be a "commercial tort claim." It could not be the "proceeds" of the debtor's trademark collateral. THOMAS M. WARD, *INTELLECTUAL PROPERTY IN COMMERCE* § 1:9 (2000).

⁵⁷ UCC [Revised] § 9-108(e)(1). Revised section 9-204(b)(2) also provides that a security interest in a commercial tort claim cannot attach under an after-acquired property clause. UCC [Revised] § 9-204(b)(2).

⁵⁸ UCC [Revised] § 9-204(b)(2).

⁵⁹ UCC § 9-105(d):

"Debtor" means the person who owes payment or other performance of the obligation secured, whether or not he owns or has rights in the collateral Where the debtor and the owner of the collateral are not the same person, the term "debtor" means the owner of the collateral in any provision of the Article dealing with the collateral, the obligor in any provision dealing with the obligation, and may include both where the context so requires. The definition of "debtor" in Revised Article Nine includes only those persons with ownership or ostensible ownership interests in the collateral. Just owing the secured debt is not enough. UCC [Revised] § 9-102(a)(28).

⁶⁰ UCC § 9-105(l): "Secured Party" means a lender, seller or other person in whose favor there is a security interest. *Accord* UCC [Revised] § 9-102(a)(72).

of collateral, the security interest must attach to that collateral for that security interest to then become enforceable against the debtor. When perfection occurs, that security interest becomes enforceable against third parties.

(1) Elements of Attachment

Section 9-203 provides that a security interest attaches on the occurrence of three events: (1) the secured party has given value to the debtor; (2) the debtor has acquired "rights" in the collateral; and (3) the debtor has signed a written "security agreement" which describes the collateral so as to enable identification, except where the debtor has agreed to transfer *possession* of the property to the secured party as collateral and the secured party takes possession of the property under this agreement.⁶¹

These events can occur in any order, but "attachment" will not occur without all three. For example, if a debtor signs an agreement giving a lender an interest in existing and properly described collateral⁶² in exchange

⁶¹ UCC § 9-203(1)(a),(b)&(c). See also UCC [Revised] § 9-203(a)&(b).

⁶² In order to satisfy the "description of the collateral" requirement in section 9-203(1)(a) the agreement must "reasonably identify what is described." UCC § 9-110. The notice document, or "financing statement" designed as the public record of the agreement is subject to a slightly less stringent description standard. A financing statement is sufficient even if does not enable the identification of specific items if it indicates the "type" of collateral covered. UCC § 9-402(1). Under Revised Article Nine "a statement to the effect that the financing statement covers *all* assets or *all* personal property is sufficient." UCC [Revised] § 9-504(2)(emphasis added). Revised Article Nine also contains a more complete and categorical guide to when a collateral description in the security agreement is sufficient. UCC [Revised] § 9-108. Revised section 9-108(b)(3) lists identification by UCC collateral type [e.g., general intangibles, equipment, accounts] as a proper mode of description. However, Official Comment 2 to Revised § 9-108 makes clear that the use of approved modes must still "make possible the identification of the collateral described." Therefore, a security interest in some, but not all, of the debtor's intellectual property (e.g., patents and patent applications) would not be properly described *in the security agreement* by the phrase "intellectual property." On the other hand, a financing statement that referred to "intellectual property" would be a sufficient "indication by type" under current § 9-402(1) even where the security agreement covered only the debtor's patents and patent applications. It is not clear that a simple "indication by type," effective for the financing statement under current § 9-402(1), is also effective under Revised § 9-504. Revised § 9-504(1) provides for two *exclusive* categories of "sufficient indication." The financing statement must contain either: (1.)] a "description of the collateral pursuant to Section 9-108;" or (2.)] "an indication that the financing statement covers all assets or all personal property." If Revised § 9-108 (dealing with the security agreement) does not allow for the simple non-quantitative reference to collateral type, then the indication by type approved in current § 9-402(1) would not be sufficient under Revised § 9-504(1) and could only work in the financing statement if it fell within

for a loan which lender *may* make at some future date, a security agreement has been executed and the debtor has rights in that existing collateral. No attachment occurs, however, until lender makes the loan or gives "value" to the debtor. If a lender or credit seller makes a *binding commitment* to loan or sell to the debtor in connection with the executed agreement, attachment occurs on the date of agreement because a binding commitment constitutes "value."⁶³ If a lender made the loan with the oral understanding that it would be secured by property in the debtor's possession, the lender has given value and the debtor has rights in the collateral. No attachment occurs, however, until the debtor signs a sufficient security agreement.⁶⁴ Finally, suppose the

the approved supergeneric language of 9-504(2) ("all assets or all personal property"). Official Comment 2 to Revised § 9-504 states that: "[i]t follows that a somewhat narrower description than 'all assets,' e.g., 'all assets other than automobiles,' is sufficient for purposes of this section" This Comment's example of a supergeneric description with a limitation does not make it clear that the simple "indication by type" that currently works for the financing statement under § 9-402(1), but not the security agreement under current § 9-203(1)(a) and § 9-110, is sufficient for a financing statement under Revised § 9-504.

⁶³ UCC § 1-201(44)(a) & § 9-105(4).

⁶⁴ The formalities of the written agreement necessary for enforceability prior to 1977 and necessary for both enforceability and attachment since 1977 are minimal. For that reason, there is no longer any need for a doctrine of equitable mortgages with respect to personal property. The doctrine served to protect those who were snared in the elaborate and technical formal requirements which marked much of the old law of personal property security. As the Official Comment to current section 9-203 observes: Since this Article reduces formal requisites to a minimum, [m]ore harm than good would result from allowing creditors to establish a secured status by parol evidence after they have neglected the simple formality of obtaining a signed writing. UCC § 9-203, cmt. 5. The observation in this Comment is particularly telling for the credit assignor of intellectual property who might expect to benefit from an *equitable* interest in the assigned property by virtue of a contractual right to terminate the assigned rights for nonpayment of the agreed price. Such a reservation by a transferor of intellectual property, intended solely to secure the payment of the price by the transferee, should also bring the interest reserved under Article Nine. Even if the transferor purports to retain "title" to intellectual property by couching the transfer as a "license," the interest retained by the transferor should be viewed as an Article Nine security interest if the nominal licensor has given the nominal licensee all meaningful rights of ownership and use for the useful life of the intangible right. The transaction's real purpose should suffice to bring the licensor's retained interest within Article Nine, giving the licensee the protection of the Article's default provisions. UCC § 9-102. *Accord* UCC [Revised] § 9-109(a)(1). *See* Warnaco, Inc. v. Farkas, 872 F.2d 539, 543 (2d Cir. 1989) ("A license of trademarks is for *present purposes* functionally indistinguishable from a lease of equipment where title is to pass for nominal consideration upon satisfaction of the debt incurred as part of a purchase of the trademarks or equipment. The *trademarks were therefore collateral* as a matter of law.") (emphasis added).

debtor signs a sufficient agreement and the loan is made, but the collateral described will be acquired by the debtor sometime in the future. In that case, the debtor's acquisition of "rights in the collateral" is the last of the three events to occur and there will be no attachment of a security interest until the debtor acquires those rights.⁶⁵

When the collateral is a form of intellectual property, this element may be problematic. For example, even before the existence of an invention, a present written assignment of the inventor's rights is effective to convey an expectant interest to the assignee.⁶⁶ The assignee of such an expectant interest does not acquire legal title to a patent application until the application is filed and does not acquire legal title to the patent until the patent issues.⁶⁷ Once the inventing debtor's conception or the assignee debtor's expectant interest is captured in a recognized form (e.g., a patent application), the issue is whether the debtor acquires rights, not only in that first protected form, but in any subsequent metamorphosis of that form into another protected form of intellectual property.⁶⁸ [See Appendix 11.]

b) Perfection and Choice of Law

"Attachment" is a prerequisite to "perfection."⁶⁹ Perfection is a status conferred on security interests once they have attached and are properly

⁶⁵ The phrase "rights in the collateral" does not refer to title and does not necessarily coincide with possession by the debtor. "Rights" in goods, for example, may arise as soon as the debtor/buyer acquires an insurable interest in them. Absent a contrary agreement, an insurable interest can be found as soon as the goods are "shipped, marked or otherwise designated *by the seller* as goods to which the contract refers . . ." UCC § 2-501(1)(b). (emphasis added). See also, e.g., UCC § 2-716(3) (Buyer's right to replevy undelivered but identified goods). Under Revised Article Nine, the debtor's "power to transfer rights" in the collateral is made the equivalent of the debtor having "rights in the collateral." UCC [Revised] § 9-203(b)(2).

⁶⁶ 19 U.S.P.Q.2d at 1511-12.

⁶⁷ *Bailey v. Chattem, Inc.*, 684 F.2d 386, 389-92 (6th Cir. 1982).

⁶⁸ The continuation of a security interest in tangible property through various changes in classification has been given judicial sanction. See, e.g., *In re Robert Bogetti & Sons*, 162 B.R. 289, 294 (Bankr. E.D. Cal. 1993) ("Once a security interest attaches to described collateral, subsequent transmigrations as to classification under section 9-109 do not defeat that security interest."); *In re Walkington*, 62 B.R. 989 (Bankr. W.D. Mich. 1986). These cases deal with changes in the *use* of existing tangible property, however, not with *new forms* of property.

⁶⁹ UCC § 9-303. See also, UCC [Revised] § 9-308(a).

revealed in a duly filed financing statement.⁷⁰ The choice of law rules in current Section 9-103 points the secured party to the correct state or states in which to file in order to perfect a security interest. Under current section 9-103(3) the proper jurisdiction for filing (for perfection or re-perfection) a security interest in a general intangible is "the jurisdiction in which the debtor is located"⁷¹ Under current section 9-103(I), the proper jurisdiction for filing a security interest in goods is the situs of those goods. In some circumstances neither the location of the debtor nor the situs of goods can be particularly simple to uncover. [See Appendix 13.]

The choice of law rules under Revised Article Nine greatly simplify interstate perfection in cases involving intellectual property. Revised Section 9-301(1) makes the law of the jurisdiction where "a debtor is located" control perfection in cases where perfection is achieved by filing.⁷² This approach eliminates the problem of distinguishing between intellectual property in its natural state as a "general intangible," from those embodied forms of intellectual property with sufficient "product" characteristics to be classified as "goods."⁷³

3. UCC Article Nine: Priority Rules

Under Article Nine, the failure to properly file and thus "perfect" an attached security interest in the debtor's intellectual property leaves the secured party vulnerable under a number of specific priority rules. These rules create exceptions from the presumptive effectiveness of the security interest under section 9-201.⁷⁴ The exceptions protect the lien creditor,⁷⁵ other secured parties,⁷⁶ and a variety of subsequent third party purchasers,⁷⁷

⁷⁰ In every case involving intellectual property collateral which is controlled by Article Nine, perfection is the combination of attachment and the proper filing of the simple half-page "financing statement." UCC §9-303 & § 9-302(1). The financing statement is designed to give rudimentary notice that a security interest in described collateral, or indicated "types" of collateral, exists or is contemplated. UCC § 9-402(1). *Accord* UCC [Revised] § 9-502(d).

⁷¹ UCC § 9-103(3)(b).

⁷² UCC [Revised] § 9-301(1) & cmt. 4.

⁷³ THOMAS M. WARD, *INTELLECTUAL PROPERTY IN COMMERCE* § 2:57 and 2:58 (2000).

⁷⁴ UCC § 9-201; UCC [Revised] § 9-201(a).

⁷⁵ UCC [Revised] § 9-301(1)(b); UCC [Revised] § 9-317(a)(2).

⁷⁶ UCC §§ 9-301(1)(a) & 9-312; UCC [Revised] §§ 9-317(a)(1), 9-322 & 9-324.

⁷⁷ UCC §§ 9-301(1)(c)&(d) & 9-306(2); UCC [Revised] §§ 9-317(b)-(d) & 9-315(a)(1).

including subsequent assignees,⁷⁸ and, to a more limited extent, subsequent licensees.⁷⁹ These priority rules apply to third parties that acquire an interest in the collateral through the secured party's debtor, in other words, a "common source." This "common source" is an important predicate for the Article Nine priority rules. When competing lienors, secured parties, or transferees acquire an interest in the collateral through someone other than the secured party's debtor, the Article Nine priority rules will yield to the derivative title predicate.⁸⁰ For example, recording provisions applicable to ownership rights in federal intellectual property may displace the unrecorded title of an assignee/debtor in favor of a subsequent transferee from the debtor's title source. Such displacement of the debtor's underlying title in the collateral will displace the derivative rights of its secured party, notwithstanding the Article Nine priority rules. [See Appendix 14.]

4. UCC Article Nine: Deferral to Federal Law

a) Complete Step-Back Provision

Current Article Nine clearly recognized the potential and actual displacing effects of the federal recording schemes through its "step-back" provisions.⁸¹ Both the current and Revised versions of Article Nine provide for complete or partial preemption of their respective rules by a controlling federal legislative structure.⁸² Transactions involving a "security interest" in personal property that are nevertheless *excluded* from the application of Article Nine are catalogued in section 9-104. The first exclusion is for a "security interest subject to any statute of the United States to the extent that

⁷⁸ UCC §§ 9-301(1)(d) & 9-306(2); UCC [Revised] §§ 9-317(d) & 9-315(a)(1).

⁷⁹ UCC §§ 9-301(1)(d) & 9-306(2); UCC [Revised] §§ 9-317(d), 9-315(a)(1) & 9-321(a)-(b).

⁸⁰ See discussion in PRELIMINARY REPORT #1: AN OVERVIEW OF THE CURRENT LEGAL STRUCTURES GOVERNING THE PERFECTION AND PRIORITY OF SECURITY INTERESTS IN INTELLECTUAL PROPERTY AND AN ANALYSIS OF PROPOSED REFORMS, Section II(b)(4)(A) (Cooperative Contract - U.S.P.T.O. and Franklin Pierce Law Center 2000). See also J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE § 24-1 at 854 (4th ed. 1995) (The common law "shelter" rule, that a buyer gets as good a title as its seller had, is grafted into Article Nine through sections 1-103 and 2-403(1)).

⁸¹ THOMAS M. WARD, INTELLECTUAL PROPERTY IN COMMERCE §§ 2:65 - 2:67 (2000).

⁸² UCC § 9-104(a). Accord U.C.C. [Revised] § 9-109(c)(1) ("This Article does not apply to the extent that: (1) a statute, regulation or treaty preempts this article; . . .").

such statute governs the rights of parties to and third parties affected by transactions in particular types of property."⁸³ The drafters designed the section 9-104(a) exclusion so that whenever the scope of a "statute of the United States" triggered the exclusion, gaps in the "statute" could be filled by looking to Article Nine. As a source of supplementary rules, the drafters were probably thinking of Article Nine as enacted in the state having the most appropriate contacts with the secured transaction at issue.⁸⁴ The preservation of some limited role for the Article Nine scheme was based on the assumption that a federal statute described in section 9-104 would *not* displace Article Nine *completely* but only "to the extent" that the federal statute *governs* the rights of the parties. The Uniform Commercial Code plays a similar, but not identical, supplementary role when federal preemption is the displacing theory.⁸⁵ Revised Article Nine has a more straightforward recognition of federal preemption. Revised Article Nine section 9-109(c)(1) provides that the Article does not apply to the extent it is preempted by "a statute, regulation, or treaty of the United States"⁸⁶

⁸³ UCC § 9-104(a). *Accord* UCC [Revised] § 9-109(c)(1) ("This Article does not apply to the extent that: (1) a statute, regulation or treaty preempts this article; . . .").

⁸⁴ "Thus if the federal statute contained no relevant provisions this article could be looked to for an answer." UCC § 9-104, cmt 1.

⁸⁵ When a judicial determination of complete preemption is made, Article Nine may still remain a source of supplementary federal common law rules. The enacted law of a particular "contact" state will often be the appropriate source for "federal common law" rules necessary to supplement the applicable federal scheme. *United States v. Kimbell Foods, Inc.*, 440 U.S. 715 (1979). *See* J. WHITE & R. SUMMERS, *THE UNIFORM COMMERCIAL CODE* § 21-10 at 752-54 (4th ed. 1995). When enacted state rules inform the federal common law, the result under the preemption doctrine should be the same as when section 9-104(a) applies. Under either approach, local law is displaced by the federal scheme but should be consulted where the federal scheme is silent. However, enacted state law will be ignored in formulating federal common law rules when there is a strong overriding interest in national uniformity and otherwise applicable state law varies from the commercial norm. *Id.* In such cases, the "Uniform Version" of Article Nine, rather than the version enacted in the "contact" state, may be the best place to find the supplementing federal common law. *Allen v. F.D.I.C.*, 599 F. Supp. 104 (E.D. Tenn. 1984); *F.D.I.C. v. Morgan*, 727 S.W.2d 500 (Tenn. Ct. App. 1986). The distinction may have limited importance, however, because there is general uniformity with respect to definitions and priority rules among the enacted versions of Article Nine.

⁸⁶ UCC [Revised] § 9-109(c)(1).

b) Partial Step-Back Provisions

Current section 9-302(3)(a) and Revised section 9-311(a)(1) provide for displacement of the Article's *filing rules* in situations where the Article is not preempted as per section 9-104(a) and a federal statute provides a registration scheme for the rights otherwise subject to Article Nine. The language of current section 9-302(3)(a) provides that the *filing requirements* of Article Nine are displaced if the collateral in question is subject to "a statute . . . of the United States which provides for a national or international registration or a national or international certificate of title" ⁸⁷

Whenever current section 9-302(3)(a) requires a "partial step-back" in recognition of a national recording system, UCC section 9-302(4) makes "compliance" with the recognized national system exclusive.⁸⁸ Furthermore, when Article Nine filing must yield, it must yield completely. The national system becomes the *exclusive* equivalent.

It is significant to note the distinctions between the current and Revised Article Nine on the issue of partial deferral. The partial deferral language in Revised Article Nine is limited to "a statute, regulation, or treaty of the United States *whose requirements for a security interest's obtaining priority over the rights of a lien creditor with respect to the property preempt [the Article Nine filing requirement for perfection].*"⁸⁹ Only Statutes with "requirements" that, if met, will allow the secured party to defeat the lien creditor are treated under the Revisions as capable of preempting Article Nine filing.

IV. THE CURRENT CONFUSION

All three federal intellectual property Acts are primarily concerned with defining the nature and scope of the owner's or creator's exclusive rights in the intellectual property and with setting out the limits on and procedures for enforcing those rights. Only a few sections in each of the Acts deal with transfer and recordation of the property rights that they create and define.⁹⁰ The recording provisions of all three federal schemes are one-dimensional in

⁸⁷ UCC § 9-302(3)(a). See also 1 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 19.9 (1965).

⁸⁸ UCC § 9-302(4) & cmt. 8.

⁸⁹ UCC [Revised] § 9-311(a)(1).

⁹⁰ Copyright Act: 17 U.S.C. §§ 101, 201, 204, 205 (1994); Lanham Trademark Act: 15 U.S.C. § 1060 (1994); Patent Act: 35 U.S.C. § 261 (1994). See also Semiconductor Chip Protection Act: 17 U.S.C. § 903 (1994).

that they focus solely on the necessity of providing purchasers of intellectual property with delayed constructive notice of prior consensual interests.⁹¹ None of these schemes deals specifically with after-acquired rights, involuntary liens, or the rights of creditors other than purchasers. The Patent Act and the Trademark Act seem to deal only with the recording of *prior* title transfers for the protection of *subsequent* title transferees.⁹² In general, the recording provisions of these schemes protect the first transfer executed as long as the transfer is recorded within a generous grace (look-back) period.⁹³ Prior unrecorded transfers can remain secret yet valid as to subsequent parties for long periods. While these provisions may be tolerable for ranking ownership rights, their long look-back periods are hopelessly cumbersome when determining lien priority. Lenders will not release committed funds before ensuring that the time for protecting any potential prior interest by recording has expired.

These lengthy federal look-back periods are exacerbated by further "office delays" which result from the fact that transfers are deemed "recorded" within the applicable look-back periods from the time they are *received* for recording, even though the internal steps necessary to make them accessible to searchers may take several months more.⁹⁴

Both the recording and priority provisions of these federal recording statutes lack the vocabulary and structure to adequately address the modern notion of a security interest. Instead, they are rooted in nineteenth century concepts of title and formal document recordation.

The federal statutory schemes governing copyrights, patents, and trademarks are distinct but have common omissions. Each makes some provision for recording, priority and derivative interests (including security interests), but none deal directly with the creation or priority of security interests. To further confuse the matter of preemption, none of these federal schemes refer to, or even acknowledge, the uniform state rules on security

⁹¹ The Copyright Act protects a "later transfer" if recorded first, and "taken in good faith, for valuable consideration" 17 U.S.C. § 205(d) (1994). The concept of taking for valuable consideration has been expanded by one Court to include the judicial lien creditor as constituted by statute in the bankruptcy trustee. See *National Peregrine, Inc. v. Capital Federal Savings & Loan Ass'n.*, 116 B.R. 194, 207 (C.D. Cal. 1990).

⁹² Patents: 35 U.S.C. § 261 (1994) ("an assignment, grant or conveyance"); Trademarks: 15 U.S.C. § 1060 (1994) ("an assignment"). The recording provision in the Semiconductor Chip Protection Act applies to "conflicting transfers of the exclusive rights in a mask work" 17 U.S.C. § 903 (1994). In contrast, section 205 of the Copyright Act applies to "[a]ny transfer of copyright ownership." 17 U.S.C. § 205(a)&(d) (1994).

⁹³ 35 U.S.C. § 261 (1994); 15 U.S.C. 1060 (1994); 17 U.S.C. § 205(d) (1994). See also 17 U.S.C. § 903 (1994).

⁹⁴ Bramson, *supra* note 33 at 1574 n.36.

interests in Article Nine. Courts struggling with preemption are left to decide whether the particular federal scheme parallels the Article Nine rules to such an extent that Congress undoubtedly intended to forestall application of state rules in favor of a particular federal rule. Because the three federal schemes differ widely in their definitions and scope, all precedent must be examined very carefully.

A. Intellectual Property Law: The Copyright Act

The Copyright Act provides the most comprehensive recording scheme of all the federal intellectual property statutes. It also presents the broadest potential overlap with state law provisions in Article Nine. Initially, the Act's breadth is reflected in its definition of a "transfer of copyright ownership".⁹⁵ The definition in section 101 of the Act includes "assignment, mortgage, exclusive license, or any other conveyance, alienation, or hypothecation of a copyright . . .".⁹⁶ This definition covers security interests, but, standing alone, arguably does not cover involuntary lien creditors who are often in conflict with the secured party.⁹⁷ However, these real and hypothetical (e.g., the bankruptcy trustee) involuntary interests, which typically engage the secured party in a contest over priority, fall ostensibly within the section 101 phrase "transfer of copyright ownership" by section 201 of the Copyright Act.⁹⁸ Section 201(d)(1) provides that "[t]he ownership of a copyright may be transferred . . . by any means of conveyance or by *operation of law*, and may be bequeathed by will or pass as personal property by the applicable laws of intestate succession."⁹⁹

Aside from this broad definition of an ownership transfer, the language concerning which documents are recordable in section 205(a) extends to any "document pertaining to a copyright."¹⁰⁰ Both the 1962 and 1972 Official Comments to Section 9-302 refer to the Federal Copyright Act

⁹⁵ A "transfer of copyright ownership" is an assignment, mortgage, exclusive license, or any other conveyance, alienation, or hypothecation of a copyright or of any of the exclusive rights comprised in a copyright, whether or not it is limited in time or place of effect, but not including a nonexclusive license. 17 U.S.C. § 101 (1994).

⁹⁶ 17 U.S.C. § 101 (1994).

⁹⁷ "Lien creditor" is defined under Article Nine as "a creditor who has acquired a lien on the property involved by attachment, levy or the like" U.C.C. § 9-301(3). *Accord* U.C.C. [Revised] § 9-102(a)(52).

⁹⁸ 17 U.S.C. § 201(d)(1) (1994).

⁹⁹ *Id.* (emphasis added.)

¹⁰⁰ 17 U.S.C. § 205(a) (1994).

as an example of "the type of federal statute referred to in subsection (3)(a)"¹⁰¹ This Comment's reference is consistent with the language in Comment 1 to section 9-104 which concludes that, while security interests in copyrights are governed generally by Article Nine, filing under the Copyright Act is "recognized as the equivalent to filing under this article."¹⁰² While the Copyright Act obviously qualifies for the partial step-back under present section 9-302(3)(a),¹⁰³ it could also fall short of the "requirements" language added by the Revisions. If a subsequent transferee of a copyright ownership interest protected under section 205(d) of the Act does not include the lien creditor, a Copyright Act recording of a security interest would not meet the "requirements" test.¹⁰⁴ Section 205(d) provides that as between two conflicting transfers, the one *executed* first prevails if it is recorded in the manner required to give constructive notice under subsection (c), within one month after its execution in the United States or within two months after its execution outside the United States, or at any time before recordation in such manner of any later transfer. Otherwise, the later transfer prevails if recorded first in such manner, and if taken in good faith, *for valuable consideration* or on the basis of a binding promise to pay royalties, and without notice of the earlier transfer.¹⁰⁵ The current cases are split on whether the "lien creditor" is a protected subsequent party under the Copyright Act's section 205(d) priority rule.¹⁰⁶ Of course, to the extent that displacement of the UCC generally, including the filing requirements, will ultimately be judged under federal law, state law step-back formulae, even those with the prestige of Article Nine behind them, will not be determinative.

National Peregrine, Inc. v. Capital Federal Savings & Loan Ass'n.,¹⁰⁷ a decision from the Federal District Court for the Central District of

¹⁰¹ UCC § 9-302, cmt. 8.

¹⁰² UCC § 9-104, cmt. 1. Again, it should be noted that while the language of the Code Comments has not changed since 1972, the Copyright Act of 1976 created a much more comprehensive priority scheme for copyrights than the scheme that was in place when the Code Comments were written. The current Copyright Act's definition of "transfer" is very broad. 17 U.S.C. §§ 101 & 201(d)(1) (1994).

¹⁰³ UCC § 9-302, cmt. 8.

¹⁰⁴ 11 U.S.C. § 205(a),(c)&(d) (1994).

¹⁰⁵ 17 U.S.C. § 205(d) (1994) (emphasis added).

¹⁰⁶ Compare *National Peregrine, Inc. v. Capital Federal Savings & Loan Ass'n.*, 116 B.R. 194, 203-04 (C.D. Cal. 1990)(lien creditor is a protected transferee under section 205(d)), with, *In re Avalon Software, Inc.*, 209 B.R. 517, 521 (Bankr. D. Ariz. 1997)(federal recording mandated under present section 9-302(3) and (4), but state law must be consulted to determine secured party/lien creditor priority).

¹⁰⁷ 116 B.R. 194 (C.D. Cal. 1990).

California, gives full preemptive effect to the broad transfer and recording language of the Copyright Act. *Peregrine* concludes that both the perfection and priority rules in Article Nine must yield to the recording and priority provisions of the federal Copyright Act. [See Appendix 15.]

The only decision to actually implement the partial step-back along the lines set out in section 9-302(3)&(4) is *In re Avalon Software*,¹⁰⁸ a Bankruptcy Court decision from the District of Arizona.¹⁰⁹ The *Avalon* decision involves copyrightable software and rejects the total step-back approach taken in the earlier *Peregrine* decision.¹¹⁰ However, *Avalon* concludes that once the displacing federal equivalent is found, "compliance" with that statute means achieving the fullest measure of recording act protection available under it. All collateral that is "copyrightable" must be perfected by full compliance with section 205 of the Copyright Act. Full "compliance" under *Avalon* means that a section 205(a) recording, by itself, is not enough. The security interest must be recorded "in the manner required to give constructive notice" within the meaning of subsection (c) of section 205.¹¹¹ In order for a recording to give constructive notice under subsection (c), the underlying copyrighted work must reasonably be identified in the document recorded, and the underlying copyrighted work must be registered.¹¹² This is a nearly impossible set of requirements for

¹⁰⁸ 209 B.R. 517 (Bankr. D. Ariz. 1997).

¹⁰⁹ The partial preemption patent cases do not follow the section 9-302(3)&(4) partial step-back. These cases preserve the effectiveness of a state Article Nine-filed financing statement for "perfection" against the bankruptcy-formed lien creditor. On the other hand, these cases also suggest (in varying degrees) that state perfection would not be enough against a subsequent assignee. *In re Cybernetic Services, Inc.*, 239 B.R. 917, 920 at n.8 (9th Cir. B.A.P. 1999); *Chesapeake Fiber Packaging Corp. v. Sebro Packaging Corp.*, 143 B.R. 360, 19 UCC2d 600 (D. Md. 1992), *aff'd*, 1993 U.S. App. LEXIS 28605 (4th cir. 1993); *City Bank and Trust Co. v. Otto Fabric, Inc.*, 83 B.R. 780, 782 (D. Kan. 1988); *In re Transportation Design and Technology, Inc.*, 48 B.R. 635, 639, 40 UCC 1393, 1398 (Bankr. S.D. Cal. 1985).

¹¹⁰ 209 B.R. at 521 (Bankr. D. Ariz. 1997) ("In other words, if another statutory means is covered by another state or federal statute, then the usual UCC methods [of filing] are superseded, and, in the case of federal statutes, preempted.").

¹¹¹ 209 B.R. at 522. The idea that full compliance includes the stipulation that the recording be "in the manner required to give constructive notice" has also been upheld in a complete step-back case involving copyright collateral. *In re AEG Acquisitions Corp.*, 127 B.R. 34, 40-41 (Bankr. C.D. Cal. 1991), *aff'd*, 161 B.R. 50, 57 (9th Cir. B.A.P. 1993); 11 U.S.C. § 205(c)&(d) (1994).

¹¹² 11 U.S.C. § 205(a),(c)&(d) (1994). It can be argued that constructive notice under subsection (c) is not technically a recording requirement. A transfer of copyright ownership can be recorded even if it is not recorded in "the manner required to give constructive notice." However, the recorded document is not afforded priority under

“copyrightable” collateral, such as trade secrets, for which the debtor does not wish to seek registration under the Copyright Act. [See Appendix 15.]

The most recent bankruptcy court decision on the subject of “perfecting” copyright collateral is *In re World Auxiliary Power Co.*¹¹³ The court in that case concluded that state law perfection under Article Nine was effective because the copyright collateral was not registered under the Copyright Act. Although *World Auxiliary Power* provides some relief to secured creditors reeling from the holdings in *Peregrine and Avalon*, the conceptual foundations for the distinction between registered and unregistered copyrights may not hold up when the decision is reviewed on appeal. [See Appendix 16.]

B. Federal Intellectual Property Law: The Patent Act

The Patent Act’s recording provision focuses exclusively on transfers that carry title and ownership rights to the transferee including patent mortgages. Because early chattel mortgage law was rooted in title concepts, the patent mortgage has been perceived historically as having an effect on title to the patent transferred for security.¹¹⁴ Despite the nontitle orientation of state chattel security law under Article Nine, a patent mortgage or collateral assignment is still conceptualized under the Patent Act as an assignment vesting title in the assignee/mortgagee.¹¹⁵ These instruments are recorded as title transfers, subject to defeasance—a condition that is officially ignored under the regulations of the Patent and Trademark Office.¹¹⁶

The root of the problem is that a chattel mortgage in its original conceptual form no longer exists. Article Nine changed the state law

subsection (d) of section 205 unless it also provides “constructive notice.” Therefore, the argument concludes, subsection (c) is a priority rule that does not trump Article Nine, rather than a “filing” requirement that must be complied with under the partial step-back mandated by UCC section 9-302(3)(a) and (4). Nevertheless, the *Avalon Software* court concludes that a security interest in a copyright is not “completely perfected” after a section 205(a) recording unless the copyright collateral is also registered so as to give constructive notice within the meaning of section 205(c) the Copyright Act. 209 B.R. at 522. The *Avalon Software* decision is discussed *infra* in Section III(b)(4) et seq.

¹¹³ See Appendix 16 for a detailed discussion of the *World Auxiliary Power* holding.

¹¹⁴ THOMAS M. WARD, INTELLECTUAL PROPERTY IN COMMERCE §§ 2:85 and 2:86 (2000).

¹¹⁵ *Id.* 35 U.S.C. § 261 (1994).

¹¹⁶ 37 C.F.R. § 3.56 (2000).

characterization of all security interests.¹¹⁷ The concept of title was removed from the equation.¹¹⁸ When seen in light of the old title concepts applied to patents, the Article Nine security interest takes the form of a conditional promise to assign rights in the future.¹¹⁹ The common law historically viewed such agreements as equitable encumbrances¹²⁰ that fell within the non-statutory bona fide purchaser rule, rather than the statutory recording rule for transfers of legal title in section 261.¹²¹ The basis of this common law rule protecting the bona fide purchaser against these contingent “equitable” assignees was drawn from state law, however, and that state law changed with the widespread enactment of Article Nine.¹²² [See Appendix 17.] *Under current state law*, an effective Article Nine filing protects the security interest (previously characterized as a contingent equitable interest) in a patent even as against a bona fide purchaser.¹²³ Despite Article Nine’s departure from concepts that underlie the current Patent Act recording and priority provisions, an argument can be fashioned that Article Nine itself

¹¹⁷ UCC § 9-202. *See In re Cybernetic Services, Inc.*, 239 B.R. 917, 920-21 (9th Cir. B.A.P. 1999)(“Section 9-202 of the UCC provides that Article 9 applies to secured transactions involving personal property regardless of ‘whether title to collateral is in the secured party or in the debtor.’ Because transferring title no longer has significance in creating a security interest in personal property, most security interests created after adoption of the UCC do not involve the transfer of title.”).

¹¹⁸ *Id.* *See also* UCC § 9-102, cmt. 1.

¹¹⁹ *City Bank and Trust Co. v. Otto Fabric, Inc.*, 83 B.R. 780, 782-83 (D. Kan. 1988), *relying on, In re Transportation Design and Technology, Inc.*, 48 B.R. 635, 639, 40 UCC 1393, 1398 (Bankr. S.D. Cal. 1985)(security interest not a present assignment). *See also* *Clorox Co. v. Chemical Bank*, 1996 TTAB LEXIS 15, 40 U.S.P.Q.2d 1098, 1100 at n.10 (TTAB 1996)(security agreement is in the nature of an agreement for a future contingent assignment); *In re 199Z*, 137 B.R. 778, 782 (Bankr. C.D. Calif. 1992)(same).

¹²⁰ *Arachnid, Inc. v. Merit Indus., Inc.*, 939 F.2d 1574, 1580-81 (Fed. Cir. 1991)(“[A] . . . provision that all rights to inventions developed during the consulting period ‘will be assigned’ by IDEA to Arachnid does not rise to the level of a present assignment of an existing invention, effective to transfer all legal and equitable rights therein” Arachnid had an equitable right only.)

¹²¹ *FilmTec Corp. v. Allied-Signal, Inc.*, 939 F.2d 1568, 1573 (Fed. Cir. 1991)(“It is well established that when a legal title holder of a patent transfers his or her title to a third party purchaser for value without notice of an outstanding equitable claim or title, the purchaser takes the entire ownership of the patent, free of any prior equitable encumbrance.”) *Hendrie v. Sayles*, 98 U.S. 546, 549, 25 L. Ed. 176 (1879) (“This is an application of the *common law bona fide purchaser for value rule*.”) (emphasis added).

¹²² The Article has displaced the concept that an agreement to transfer for security creates an equitable encumbrance. UCC § 9-203, cmt. 5.

¹²³ UCC § 9-301(1)(d). *Accord* UCC [Revised] § 9-317(d).

defers to the Patent Act either under the complete step-back provided under section 9-104 or under the partial step-back for substitute filing provided for under section 9-302(3).¹²⁴

The language of section 261 of the Patent Act provides: [a]n assignment, grant or conveyance (of a patent, patent application, or interest therein) shall be void as against any subsequent purchaser or mortgagee for a valuable consideration, without notice, unless it is recorded in the Patent and Trademark Office within three months from its date or prior to the date of such subsequent purchase or mortgage.¹²⁵ [See Appendix 18.]

The regulations limit the definition of "assignments" to include complete or partial transfer of *right, title and interest*.¹²⁶ The title that must be transferred is the entire title including the legal title.¹²⁷ Although the

¹²⁴ THOMAS M. WARD, *INTELLECTUAL PROPERTY IN COMMERCE* §2:87 (2000).

¹²⁵ 35 U.S.C. § 261 (1994). The language of section 261 instructs that an "assignment, grant or conveyance" be recorded within three months from its "date." In the case of an assignment of an existing patent or application, "its date" is the execution date of the assignment document. However, when "an assignment of rights in an invention is made prior to the existence of the invention, this may be viewed as an assignment of an expectant interest. An assignment of an expectant interest can be a valid assignment." *FilmTec Corp. v. Allied-Signal, Inc.*, 939 F.2d 1568, 1572 (Fed. Cir. 1991). The effective "date" of such an assignment is not the date of its execution, however, because legal title does not pass until "the invention is made and an application for patent is filed." *Id.* The three-month grace period should not begin to run until the effective date of the assignment. Indeed, the document that created the present assignment of the expectant interest is not recordable until it complies with the identification requirements in 37 C.F.R. § 3.21. The original document can be made recordable once a patent application is filed by the authorized addition of the application number. The USPTO suggests that "an assignment be written to allow entry of the identifying number after the execution of the assignment. An example of acceptable wording is: 'I hereby authorize and request my attorney, (Insert name), of (Insert address), to insert here in parentheses (Application number _____, filed _____) the filing date and application number of said application when known.'" *Manual of Patent Examining Procedure* [hereinafter MPEP] § 302.02 (1997).

¹²⁶ 35 U.S.C. § 261 (1994).

¹²⁷ "Assignment means a transfer by a party of all or a part of its right, title and interest in a patent or patent application" 37 C.F.R. § 3.1 (1994). "The Manual of Patent Examining Procedure (7th ed. 1998) ('Patent Manual') is published by the Patent Office to provide a reference work on Patent Office practices and procedures. It is clear from the Patent Manual that the Patent Office does not consider a security interest or lien to be an assignment subject to the mandatory recording provision of 37 C.F.R. 3.11. The recording of assignment documents is governed by section 302 of the Patent Manual. Section 302 cites the language of 37 C.F.R. 3.11 pertaining to assignments of applications, patents and registrations as documents which 'will be recorded.' In contrast, Section 313 denotes security interests as documents other than assignments and provides that these documents, which do not affect title, 'may be recorded at the

section provides for mortgages cast as title transfers, it was not designed to handle the transfer of interests that do not affect title.¹²⁸ The Patent Act describes even partial transfers as assignments of some part of the transferor's *title*.¹²⁹ If the parties express an intention to pass present title to the secured party in the transfer document, then the regulations would consider the transfer document (e.g., modified title-bearing security agreement, conditional assignment, or patent mortgage) an "assignment" for recording purposes. The deficient conditions in these documents will be ignored by the USPTO.¹³⁰ However, whenever the parties intend that only a security interest pass to the transferee/secured party, with the rights of ownership remaining in the transferor, the transfer document is not considered an assignment under the regulations,¹³¹ and would not be recorded for constructive notice within the section 261 mandate for an "assignment, grant or conveyance."¹³²

The USPTO regulations specify that "other documents . . . *affecting title* . . . will be recorded as provided in this part or at the discretion of the Commissioner."¹³³ Even a plain "security agreement" is specifically referred to as a *recordable document* in the Comments accompanying revised section 3.31 of 37 C.F.R. It is not clear how this new regulatory language applies to

discretion of the Commissioner.' Documents that convey a security interest are recorded under Section 313 'in the public interest in order to give third parties notification of equitable interests or other matters relevant to the ownership of a patent or application.'" *In re Cybernetic Services, Inc.*, 239 B.R. 917, 921 at n.10 (9th Cir. B.A.P. 1999). See MPEP, *supra* note 125. See also 5 WALKER ON PATENTS, at § 19:4 @ 333-34 (1986):

"An assignment of a patent is an instrument in writing, which in the eye of the law, purports to convey the entire title to that patent or to convey an undivided share in that entire title." (emphasis added.)

¹²⁸ 37 C.F.R. § 3.56 (2000).

¹²⁹ 37 C.F.R. § 3.1 (2000).

¹³⁰ 37 C.F.R. § 3.56 (1994).

¹³¹ Response to Public Comment on 37 C.F.R. § 3.56, 57 Fed. Reg. 29640 (July 6, 1992): "Response: Section 3.56 [on conditional assignments] is applicable only to assignments, as they are defined by § 3.1, that is, a transfer of right, title and interest in a patent or a trademark. A security interest or a security agreement is in the nature of a lien, not an assignment. Accordingly, § 3.56 would not apply to security interests or security agreements which are also recordable."

¹³² See *Holt v. U.S.*, 13 UCC 336, 338-39 (U.S. Dist. Ct. D.C. 1973); Bramson, *supra* note 33 at 1584; "Such documents are recorded in the public interest in order to give third parties notification of equitable interests or other matters relevant to the ownership of a patent or application." MPEP, *supra* note 125 at § 313 (emphasis added).

¹³³ 37 C.F.R. § 3.11 (2000).

security agreements. Under Article Nine, security agreements transfer a *security interest* to the transferee, but they do not transfer "title," *unless the parties intend that result*.¹³⁴ It seems to follow that the recording of a nontitle-bearing security interest is discretionary under the regulations.¹³⁵ Under their internal regulations, the USPTO has chosen to provide assignment-like notice of security interests by giving them equal dignity with assignments on the cover sheet.¹³⁶ The USPTO policy is a convenience for searchers¹³⁷ but it does not expand the statutory scope of the constructive notice.¹³⁸ The fact that a security interest filed as a discretionary document with the USPTO is not statutory constructive notice, however, does not mean that such a filing cannot have legal effect. A discretionary filing should provide actual or inquiry notice to all those prospective purchasers or mortgagees who actually consulted the USPTO record.¹³⁹

¹³⁴ UCC § 2-401, § 9-102 & § 9-101, Comment 9. Comment 9 to section 9-101 reads: "This Article does not determine whether title to collateral is in the secured party or in the debtor and adopts neither a title theory or a 'lien theory' of security interests. Rights, obligations and remedies under the Article *do not depend on the location of title* (Section 9-202). The location of title may become important for other purposes - as, for example, in determining the incidence of taxation - and in such a case the parties are left free to contract as they will. In this connection the use of a form which has traditionally been regarded as determinative of title (e.g., the conditional sale) could reasonably be regarded as evidencing the parties' intention with respect to title to the collateral." (emphasis added.)

¹³⁵ Comment to 37 C.F.R. § 3.31, 57 Fed. Reg. 29636 (July 6, 1992).

¹³⁶ Changes in Patent and Trademark Assignment Practices - Discussion of Specific Sections to be Changed or Added, 57 FED REG. 29634, 29637 (1992). ("Section 3.31 is added to set out the formal requirements of the cover sheet. Section 3.31 requires that each patent or trademark cover sheet must contain . . . (3) a brief description of the interest conveyed or transaction to be recorded (e.g., assignment, license, change of name, merger, security agreement, etc.) . . .").

¹³⁷ See discussion in PRELIMINARY REPORT #1 *supra* note 80 at fn 531.

¹³⁸ "This result is not altered by the fact that, as in this case, the Patent Office accepts the filing of documents memorializing the granting of a security interest in a trademark. The Lanham Act gives the Patent Office the discretion to accept various documents not expressly described in the Act; it does not, however, expressly provide for the filing of documents memorializing pledges of trademarks, as the Copyright Act does for hypothecations of copyrights." *In re 199Z*, 137 B.R. 778, 782 at n.7 (Bankr. C.D. Calif. 1992).

¹³⁹ 35 U.S.C. § 261 (1994) ("purchaser or mortgagee . . . without notice"). See *In re Cybernetic Services, Inc.*, 239 B.R. 917, 921 at n.10 (9th Cir. B.A.P. 1999) ("Because the Patent Manual expressly 'does not have the force of law or the force of the rules in Title 37 of the Code of Federal Regulations,' see Foreword to Patent Manual, it appears that the discretionary recording is for purposes of providing actual notice rather than the constructive notice provided through provisions of Article 9 of the UCC.").

1. Deferral to the Patent Act

While the Patent Act does not seem to qualify for application of the "complete step-back" deferral, it is unclear whether it does provide a "national registration" substitute that would be sufficient to qualify the Patent Act for the "partial step-back" from Article Nine filing as set forth in UCC section 9-302(3)(a) or for some other more limited or partial form of federal preemption.

Unlike the Copyright Act, the Patent Act is not mentioned in Comment 8 to section 9-302 where examples of "partial step-back" federal statutes are provided. Unfortunately, the Official Comments following section 9-104, mention the Patent Act in a passing reference that raises more questions than it answers. The Comment to section 9-104 contains a footnote-like reference inviting readers, to "[c]ompare also with respect to patents, 35 U.S.C. § 47."¹⁴⁰ Section 47 was the nearly identical predecessor to current section 261 of the Patent Act. After this express reference to old section 47, the Official Comment to section 9-104 continues with the following language: "The filing provisions under *these Acts*, like the filing provisions of the Federal Aviation Act, are recognized as equivalent to filing under this Article. Section 9-302(3) and (4)."¹⁴¹ If "these Acts" refer to enactments previously named in the Comment, *other than the Federal Aviation Act*, then the drafters were implying that the recording provisions of the Patent Act also created a system of "national registration" for purposes of the section 9-302(3)(a) partial step-back.

If the "compare" reference in section 9-104 Official Comment 1 suggests a contrast between the Copyright Act and the stronger "title" orientation of the Patent Act, then the proper inference recognizes the more limited scope of recording under the Patent Act. If the "compare" language suggests contrast, then the reference in the section 9-104 comments to "these acts" would not include the Patent Act and instead should be taken merely as a general reference to all present or future federal recording schemes that mimic the Federal Aviation Act.¹⁴² Under this latter view of the Official Comment to section 9-104, recording under the Patent Act would *not* be

¹⁴⁰ *Id.*

¹⁴¹ *Id.* (emphasis added).

¹⁴² Unlike the Patent Act, the Federal Aviation Act provides for "a system of recording...the following: Any conveyance which affects the title to, *or any interest in*, any civil aircraft of the United States." (emphasis added). 49 U.S.C. app. § 1403(a) (1988). "Conveyance" is defined in the Federal Aviation Act to include an "instrument affecting title to, *or interest in*, property." (emphasis added). 49 U.S.C. app. at § 1301(20).

viewed as a section 9-302(3)(a) substitute for perfection by filing under Article Nine.¹⁴³

Nothing in the prior conceptual structure of state law *would require* that Article Nine security interests (that do not support a title-bearing construction) be treated as "assignments" in section 261 of the Patent Act.¹⁴⁴ Since the typical Article Nine security agreement is not title-bearing, very little support exists for a state law deferral to section 261 as a substitute mode of filing for Article Nine perfection.¹⁴⁵

2. Preemption of Article Nine Under the Patent Act

Predominantly, preemption has merely been suggested in dicta. The suggestions have been restricted to some probable application of the Patent Act priority rule in section 261 to conflicts between secured parties and federal assignees. It is difficult to extrapolate any coherent theory of preemption from the holding and dicta of these cases, however. The recent decisions seem to revert to the pre-Article Nine conception of a transfer of

¹⁴³ See *In re Cybernetic Services, Inc.*, 239 B.R. 917, 923 (9th Cir. B.A.P. 1999)(distinguishing patents from copyrights, aircraft and railroad equipment for purposes of the section 9-302(3)(a) partial step-back). Revised Article Nine contains an even tougher standard for any preemptive filing. The language in Revised section 9-311(a)(1) limits application of the step-back to "a statute, regulation, or treaty of the United States whose requirements for a security interest's obtaining priority over the rights of a lien creditor with respect to the property preempt [the Article Nine filing requirement for perfection]." UCC [Revised] § 9-311(a)(1)&(b) (emphasis added). Only statutes with "requirements" that, if met, will allow the secured party to defeat the lien creditor are treated, under the Revision language, as capable of displacing the Article Nine filing requirements. Clearly the Patent Act would not have sufficient "requirements" to trigger a partial step-back under this new language.

¹⁴⁴ The argument for preemption is based on the assumption that because the Patent Act provided for the federal filing of a patent mortgage under the "title" regime in effect under the state laws of the late nineteenth century, present day security interest transfers must be cast in title form and recorded under section 261. Note, *Perfection of Security Interests in Intellectual Property: Federal Statutes Preempt Article 9*, 57 GEO. WASH. L.R. 135, 151 (1988). See discussion in PRELIMINARY REPORT #1, *supra* note 80 at Section III(c)(1)(B).

¹⁴⁵ As noted earlier, there is support for this position in the dicta of the *Peregrine* decision. See *National Peregrine, Inc. v. Capital Federal Savings & Loan Ass'n.*, 116 B.R. 194, 203-204 & 206 n.17 (C.D. Cal. 1990)[a Copyright Act case that contains dicta to the effect that the Patent Act provides a system of "national registration" that is a complete substitute for Article Nine filing under UCC§ 9-302(3)(a)&(4)]. Contrary cases recognizing the effectiveness, for "perfection" purposes, of the Article Nine filing on patent collateral are discussed in PRELIMINARY REPORT #1, *supra* note 80 at Section III(c)(3)(C) et seq.

patent rights for security set out in the 1890 Supreme Court decision of *Waterman v. Mackenzie*.¹⁴⁶ [See Appendix 19.]

Recent cases indicate that a transfer for security should be formed and recorded in its older title characterization when priority in the ownership chain is at issue.¹⁴⁷ These cases strongly suggest that Article Nine recording and priority rules would thus be partially preempted by the Patent Act.¹⁴⁸ If a security interest is an "assignment, grant or conveyance," subject to possible avoidance under section 261, then the Patent Act preempts Article Nine when the contest is between the secured party and assignees—and perhaps when between the secured party and other secured parties. At the "protected parties" end of section 261, "purchasers and mortgagees" seem to be *expressly* included within the class of takers protected against any prior unrecorded "assignment, grant or conveyance."¹⁴⁹ [See Appendix 20.]

C. *Federal Intellectual Property Law: The Lanham Trademark Act*

Section 1060 of the Lanham Act contains the most abbreviated statement on the recording of transfers in all three of the major federal intellectual property statutes. Section 1060 of the Act provides: [a]n *assignment* shall be void as against any subsequent purchaser for valuable consideration without notice, unless it is recorded in the Patent and Trademark Office within three months after the date thereof or prior to such subsequent purchase.¹⁵⁰ Only "assignments" of registered marks and applications to register (other than intent-to-use applications) need be recorded to ensure protection against "subsequent purchasers."

¹⁴⁶ 138 U.S. 252 (1890).

¹⁴⁷ See discussion in PRELIMINARY REPORT #1, *supra* note 80 at Section III(c)(3)(C) et seq.

¹⁴⁸ See discussion in PRELIMINARY REPORT #1, *supra* note 80 at Section III(c)(3)(C)(v).

¹⁴⁹ Although the issue is not free from doubt, the secured party is probably a "purchaser" within the meaning of section 261 of the Patent Act. See discussion *supra* Section III(c)(4).

¹⁵⁰ 15 U.S.C. § 1060 (1994). Assignments of applications to register (other than intent-to-use applications) are included. 37 C.F.R. § 3.11 (1997)("applications, patents, and registrations"); 37 C.F.R. § 3.85 (1997)("certificate of registration may be issued to the assignee of the applicant . . . provided . . . the appropriate document is recorded in the Office. . . ."); 37 C.F.R. § 3.16 (1997)(Before filing an allegation of use "an applicant may only assign an application to register a mark . . . to a successor to the applicant's business, or portion of the business, to which the mark pertains, if that business is ongoing and existing.").

Section 1060 does not even mention "mortgagees" as protected subsequent parties.¹⁵¹ This stark skeletal structure is no accident. Given the dependent and ancillary character of the trademark, it is not surprising that section 1060 provides recording only for those transferees who are potential users of the mark. When this characteristic is considered in conjunction with the fact that trademarks do not share the same historical link to title-based chattel mortgage theory with patents, it appears section 1060 was intended as a recording act for true assignments only. Such an interpretation would make section 1060 inapplicable to security transfers that might otherwise be artificially conceptualized as assignments.¹⁵²

The meager case law on point adopts such logic that a security interest in a trademark registration is a non-title bearing transaction outside the scope of section 1060.¹⁵³ None of the cases decided to date have held that the Lanham Act preempts any part of the filing, perfection or priority scheme of Article Nine.¹⁵⁴ The reasoning of these cases suggests that a security interest that is properly perfected under Article Nine in the appropriate state

¹⁵¹ 15 U.S.C. § 1060 (1994). The 1988 Trademark Revision Act made extensive revisions to the federal trademark registration system. See Pub. L. 100-667, 102 Stat. 3938 (Nov. 16, 1988), *codified at* 15 U.S.C. § 1053 *et seq.* (1994). An earlier version of the legislation contained a detailed set of rules governing the recording and priority of security interests in federal trademarks which would have preempted most of the Article Nine system. See S. 1883, 100th Cong., 1st Sess. § 10(b)-(f) (1987), 133 Cong. Rec. S 16548-49 (Nov. 19, 1987) (unenacted). A recorded security interest was given priority over "interests subsequently granted." *Id.* at § 10(b). This ambitious provision was dropped from the final enacted version of the 1988 Act. In its current form, the Lanham Act makes no provision for security interests. Again, the dependent nature of the typical trademark transfer, and the absence of a title-related tradition around the taking of trademarks as collateral, make it hard to find a "security interest" within the section 1060 concept of an "assignment."

¹⁵² *Roman Cleanser v. National Acceptance Co.*, 43 B.R. 940, 945 (Bankr. E.D. Mich. 1984), *aff'd*, 802 F.2d 207 (6th Cir. 1986); *In re 199Z, Inc.*, 137 B.R. 778, 781-82 (Bankr. C.D. Cal. 1992). See also *In re C.C. & Co.*, 85 B.R. 485, 487 (Bankr. E.D. Va. 1988) ("A grant of a security interest is merely a device to secure indebtedness.").

¹⁵³ See e.g., *In re Together Development Corp.*, 227 B.R. 439, 441 (Bankr. D. Mass. 1998); 43 B.R. at 946; 137 B.R. at 781; 85 B.R. at 486-87; *In re Chattanooga Choo-Choo Co.*, 98 B.R. 792, 796 (Bankr. E.D. Tenn. 1989); *In re TR-3 Indus.*, 41 B.R. 128, 131 (Bankr. C.D. Calif. 1984); *Li'l Red Barn, Inc. v. Red Barn Systems, Inc.*, 322 F. Supp. 98, 107 (N.D. Ind. 1970).

¹⁵⁴ Even *Peregrine*, the vanguard case on complete preemption, indicated in dicta that the Lanham Act "contains no provision for the registration, recordation or filing of instruments establishing security interests in trademarks." *National Peregrine, Inc. v. Capital Federal Savings & Loan Ass'n.*, 116 B.R. 194, 204 n.14 (C.D. Calif. 1990).

should give the secured party priority, even against a subsequent purchaser of the trademark registration.¹⁵⁵

1. Partial Preemption

One knowledgeable commentator has suggested that the parallel administrative structure for patents and trademarks will lead Courts to follow the patent preemption cases when trademark registrations or eligible applications to register are used as collateral.¹⁵⁶ Similarly, it must be noted that no trademark case to date has actually tested the partial preemption concept, which first arose, with respect to patents, in dicta in *In re Transportation Design and Technology, Inc.*¹⁵⁷ [See Appendix 11.] Given the administrative interrelationship between patents and trademarks, the possibility always exists that Article Nine perfection may be insufficient when the secured interest conflicts with the interest of a subsequent assignee of a trademark. That possibility has prompted some commentators to recommend dual transactional structures and dual filing (a financing statement filed under Article Nine and an outright collateral or conditional assignment within the mandatory recording requirement of section 1060).¹⁵⁸ One commentator, flying in the face of the cases to date, has suggested that the secured party *file the financing statement* covering trademark registrations with the USPTO, "or else the security interest may be unperfected."¹⁵⁹

¹⁵⁵ UCC § 9-301(1)(d); UCC [Revised] § 9-317(d).

¹⁵⁶ See Marci L. Klumb, Note, *Perfection of Security Interests in Intellectual Property: Federal Statutes Preempt Article 9*, 57 GEO WASH. L. REV. 135, 163 (1988).

¹⁵⁷ See *In re Transportation Design and Technology, Inc.*, 48 B.R. 635, 639-40 (1985).

¹⁵⁸ See 2 J. THOMAS MCCARTHY, MCCARTHY ON TRADEMARKS AND UNFAIR COMPETITION § 18:1 at 797 (4th ed. 1997) ("Until either the U.C.C. or the Lanham Act is clarified the courts should treat either federal or state recordation of a conditional security assignment as sufficient to perfect such a security."); B. Clark, THE LAW OF SECURED TRANSACTIONS ¶ 1.8(1)(e) @ n.159 (1980); Bramson, *supra* note 6 at 1578-79. See also Baila H. Celedonia, *Advanced Seminar on Trademark Law 1996: Trademarks as Collateral*, 438 PLI/PAT. 479, 482 (April 1996) ("the recording with the USPTO of the lien against trademark registrations and pending applications is constructive notice to subsequent purchasers for value.")

¹⁵⁹ Martin E. Hsia, *Pitfalls of Intellectual Property: What You Don't Know Could Lead You To Malpractice*, 1995-APR. HAW.B.J. 26,27. At least one Bankruptcy Court has concluded that the filing of a financing statement with the USPTO will not "perfect" a security interest in a federally registered trademark. See *In re Together Development Corp.*, 227 B.R. 439, 441 (Bankr. D. Mass. 1998). Note that a *financing statement*, by itself, may not be recordable even as a discretionary recording under the regulations. It is

If USPTO recording becomes necessary because the patent cases are extended, the assignment categories for recording trademarks under the regulations would be the same as those applicable to patents. In particular, the USPTO recordation rule on "conditional assignments" applies to trademarks as well as patents. Under 37 C.F.R. § 3.56, a "conditional assignment" will be handled in the recording office as if it was an "absolute assignment."¹⁶⁰ Any "conditional assignment" under 37 C.F.R. § 3.56 (as distinguished from a contingent assignment or agreement to assign) is a present assignment of the mark subject to defeasance. Although this kind of transfer works for patents as long as the assignee/secured party bears a share of the risks of ownership, it is an extremely problematic device when used in connection with the taking of a security interest in a trademark.¹⁶¹ Remember that, unlike a contingent assignment, a conditional assignment is a present assignment that must be accompanied by enough goodwill or other business assets of the debtor to avoid being unenforceable as an assignment in gross.¹⁶²

a pure notice document that can be executed before any actual transfer has occurred. See UCC § 9-402(1); U.C.C. [Revised] § 9-502(d). It does not really "affect title" within the meaning 37 C.F.R. § 3.11 (1997). The Article Nine *security agreement* is recordable as a discretionary document. But a security interest filed with the USPTO would not perfect for Article Nine purposes according to *Roman Cleanser* and other trademark registration cases. If the partial preemption dicta from the patent cases gets applied to trademark registrations, a recorded security agreement (so formed) will still not be constructive notice within the assignment instruction of section 1060. Nevertheless, because of the uncertainty surrounding perfection, secured lenders trying to avoid the downside risks of forming their secured transaction as an assignment may want to file their security agreement at the USPTO as an additional precaution, after filing the primary financing statement in the proper state office. Although such a recording will not be constructive notice if *Transportation Design* extends to trademark registrations, the discretionary filing may provide fatal actual or inquiry "notice" to section 1060 "subsequent purchasers" who rely on the USPTO record.

¹⁶⁰ See 40 U.S.P.Q.2d at 1101 n.10.

¹⁶¹ The internal largess of the USPTO cannot expand the narrow constructive notice limits on the section 1060 mandate to record "assignments." *In re 199Z*, 137 B.R. 778, 782 n.7 (Bankr. C.D. Calif. 1992). See also discussion in PRELIMINARY REPORT #1, *supra* note 80 at Section III(d)(C); Simensky, *Enforcing Creditors' Rights*, *supra* note 143 at 570-78.

¹⁶² *United Drug Co. v. Theodore Rectanus Co.*, 248 U.S. 90, 97 (1918) ("There is no such thing as property in a trademark except s a right appurtenant to an established business or trade in connection with which the mark is employed . . ."); *Visa, U.S.A., Inc. v. Birmingham Trust Nat'l Bank*, 696 F.2d at 1375 ("[A] mark may be transferred only in connection with the transfer of the goodwill of which it is part. A naked transfer of the mark also known as a transfer in-gross is invalid."); *Glamorene Products Co. v. The Procter & Gamble Co.*, 538 F.2d 894 (C.C.P.A. 1976). But see *North American Free Trade Agreement*, opened for signature Dec. 8, 1992, 32 I.L.M. 605, art. 1708:11 [hereinafter *NAFTA Treaty*]; *Agreement on Trade-Related Aspects of Intellectual*

Furthermore, any license back of the trademark to the real owner would make the lender responsible for monitoring the licensee's use of the mark.¹⁶³ Without such monitoring, the license may be viewed as a "naked license," which results in an abandonment of rights in the mark.¹⁶⁴ The mark itself, not just the validity of the transfer, may be put at risk when a present assignment (even one subject to the condition subsequent of defeasance) is used as a security devise.

2. Title Document Transfer: the *Clorox* Case

The use of a present assignment of a trademark to create a security interest can have disastrous consequences if the collateral assigned includes the debtor's rights in an intent-to-use application. In *Clorox Co. v. Chemical Bank*,¹⁶⁵ the Trademark Trial and Appeal Board *invalidated* a debtor's registered trademark because the intent-to-use application from which it issued was made the subject of an outright assignment to the bank under terms of a collateralized loan agreement.¹⁶⁶ It appeared the assignment mechanism was used merely to carry out the intent of both parties that the assigned rights serve as security for the debtor's credit obligation. The bank clearly had no "intent to use" the mark. Nevertheless, the *Clorox* Court found the unconditional assignment device itself violated congressional policy against trafficking in or profiting from the sale of intent-to-use

Property Rights, Including Trade in Counterfeit Goods, Dec. 15, 1993, ee I.L.M. 81, art. 21.

¹⁶³ *Dawn Donut Co. v. Hart's Food Stores, Inc.*, 267 F.2d 358, 367 (2d Cir. 1959). If the licensee and licensor provide similar goods or services, the licensor might be allowed to rely on the licensee to police and maintain the quality of the mark. See *Visa U.S.A. v. Birmingham Trust National Bank*, 696 F.2d 1371, 1376 (Fed. Cir. 1982), *cert denied sub nom.*, *South Trust Bank of Alabama, Birmingham v. Visa U.S.A., Inc.*, 464 U.S. 826 (1983). In other cases, a long-term relationship between the parties might justify turning quality control over to the licensee. See *Transgo, Inc. v. Ajac Transmission Parts Corp.*, 768 F.2d 1001, 1017-18 (9th Cir. 1985), *cert denied*, 474 U.S. 1059 (1986). A security interest between an institutional lender and a borrower who owns the mark would seem to fall outside both of these exceptions.

¹⁶⁴ *First Interstate Bancorp v. Stenquist*, 16 U.S.P.Q.2d 1704, 1706 (N.D. Cal. 1990) ("[I]t is well established that where a trademark owner engages in naked licensing, without any control over the quality of goods produced by the licensee, such a practice is inherently deceptive and constitutes abandonment of any rights to the trademark by the licensor").

¹⁶⁵ 1996 TTAB LEXIS 15, 40 U.S.P.Q.2d 1098 (TTAB 1996).

¹⁶⁶ 40 U.S.P.Q.2d at 1102-03.

applications.¹⁶⁷ In fashioning a remedy, the Court relied on the legislative history behind the 1988 amendments to section 1060 to determine that cancellation of the mark, rather than simple invalidation of the assignment, was appropriate.¹⁶⁸

3. Assignments

Although the risks of using an absolute or "conditional assignment"¹⁶⁹ of a trademark outweigh any possible advantage, secured parties would be well advised to record their Article Nine security agreements *with the* USPTO, in addition to filing their Article Nine financing statements in the appropriate state office. Great care should be taken, however, to form the transfer as a ordinary security agreement - not a present assignment. So formed, such a recording could cover trademark registrations and pending "non-intent-to-use" applications. Under the recording regulations applicable to both patents and trademarks, "other documents . . . affecting title to . . . registrations, will be recorded as provided in this part or at the discretion of the Commissioner."¹⁷⁰ A security interest in a trademark can be formed as a *recordable document* under the joint regulations covering the recording of both patents and trademarks.¹⁷¹ While such a discretionary recording is not constructive notice,¹⁷² it may provide fatal actual or inquiry notice to section 1060 "subsequent purchasers" who rely on the USPTO record.

Presently, a typical security agreement in a mark can and should provide for a *future contingent assignment* of the mark or application on the debtor's default.¹⁷³ Because no present title passes, there is no absolute need

¹⁶⁷ 40 U.S.P.Q.2d at 1102-03. It would not have helped Chemical Bank if they had called the document a "security agreement" or "security interest" on the cover sheet. The Court indicated that it would examine the substance of the agreement. 40 U.S.P.Q.2d at 1101. See also *Changes in Practice*, *supra* note 136 at 29639 ("The document will always speak for itself.").

¹⁶⁸ 40 U.S.P.Q.2d at 1103-04.

¹⁶⁹ 37 C.F.R. § 3.56 (1992).

¹⁷⁰ 37 C.F.R. § 3.11 (2000).

¹⁷¹ 37 C.F.R. §§ 3.1, 3.11 & 3.56 (1994); *Changes in Practice*, *supra* note 136 at 29636 & 29640. See discussion in PRELIMINARY REPORT # 1, *supra* note 80 at Section III(c)(1)(C).

¹⁷² See e.g., *supra* note 161. *In re 199Z*, 137 B.R. 778, 782 n.7 (Bankr. C.D. Cal. 1992).

¹⁷³ A security agreement on an intangible is, in effect, an agreement to assign on the event of a default. They are contingent assignments. On the other hand, the "conditional assignment" referred to in § 3.56 is a present assignment subject to reverter on condition of payment. However, there is understandable confusion. The phrase "conditional assignment" has been used to refer to agreements to assign in the future as well.

to transfer goodwill, and no assignment in gross results. However, if an event of default occurs and the secured party must realize on its trademark collateral, any present operative assignment at default, including one provided for with a power of attorney attached to the security agreement, would have to comply with section 1060.¹⁷⁴ Secured creditors may try to hedge their bets by having a present assignment with appurtenant goodwill executed at the same time as the security agreement and instruct an escrow agent to record it only if the debtor defaults. It should be noted, however, that a Court following the *Clorox* rationale would view this scenario as akin to an executed and recorded assignment. In the case of an intent-to-use application, use of both would raise the same "trafficking" objection that led the *Clorox* Court to cancel the registration.

4. Subsequent Purchaser

A security interest appears to fall outside the definition of an assignment and beyond the policy on recordable trademark assignments such that a secured party could be a section 1060 "subsequent purchaser" protected against some real unrecorded assignments.¹⁷⁵ The state law rule in UCC section 9-301(1)(d) would give priority to the prior transferee/assignee of the mark as long as the transferee/assignee "gave value" before perfection.¹⁷⁶ Because value is broadly defined under section 1-201(44),¹⁷⁷ it

Borrowing from respondent's brief, the Trademark Trial and Appeal Board in *Clorox Co. v. Chemical Bank* [1996 TTAB Lexis 15, 40 U.S.P.Q.2d 1098 (TTAB 1996)] referred to a *contingent* assignment as an effective non-title bearing security device. 40 U.S.P.Q.2d at 1101 n.10. This contingent assignment was described simply as an agreement to assign a trademark in the future (on an event of default). In the excerpt taken from *Clorox*, this same agreement to assign in the future was also referred to as a "conditional assignment." *Id.* So defined, this kind of "conditional assignment" is not the same as the present assignment subject to defeasance in 37 C.F.R. § 3.56. See THOMAS M. WARD, INTELLECTUAL PROPERTY IN COMMERCE §2:86 (2000) Because an agreement to assign at the occurrence of a future event (under whatever label) is not a present assignment, it risks neither trafficking nor the perils of an assignment in gross. Because it is not an assignment, it should not fall within the USPTO mandate that conditional assignments be treated as absolute. As a form of security interest, however, it should be recordable at the Commissioner's discretion. 37 C.F.R. § 3.11 (2000).

¹⁷⁴ 1 J. THOMAS MCCARTHY, MCCARTHY ON TRADEMARKS AND UNFAIR COMPETITION § 18:1(G) § 796 (2d ed. 1984).

¹⁷⁵ See the discussion on the meaning of "subsequent purchaser" under the Patent Act in PRELIMINARY REPORT #1, *supra* note 80 at Section III(c)(4).

¹⁷⁶ UCC § 9-301(1)(d). *Accord* U.C.C. [Revised] § 9-317(d).

¹⁷⁷ UCC § 1-201(44).

seems unlikely that a prior assignee of a trademark would ever lose to a subsequent secured party under the state law rule protecting "transferees" in section 9-301(1)(d), whether or not the assignee/transferee ever recorded. The secured party might seek to argue for preemption, therefore, whenever the prior assignee fails to record within three months or prior to the attachment of the subsequent security interest. A similarly protected "purchaser" under the Patent Act can be defined to include a party who takes a security interest in the whole right.¹⁷⁸ Under the UCC, a purchaser includes one who takes by "mortgage, pledge or lien . . .".¹⁷⁹ Courts have looked to the Commercial Code as a source for federal common law definitions on other occasions.¹⁸⁰

Finally, even if section 1060 of the Trademark Act is held to partially preempt Article Nine as to federally registered trademarks, the lender should *still* file under Article Nine. Section 1060 does not deal with lien creditor rights whatsoever; thus, lien creditor priority will surely depend on state law perfection.¹⁸¹ Furthermore, unregistered trademarks are wholly

¹⁷⁸ See the discussion on the meaning of "subsequent purchaser" under the Patent Act at Section III(c)(4).

¹⁷⁹ UCC § 1-201(32)&(33). *Accord* UCC [Revised] § 1-201(32)&(33).

¹⁸⁰ When a judicial determination of complete preemption is made, Article Nine may still remain as a source of supplementary federal common law rules. The enacted law of a particular "contact" state will often be the appropriate source for "federal common law" rules necessary to supplement the applicable federal scheme. *United States v. Kimbell Foods, Inc.*, 440 U.S. 715 (1979). See J. White & R. Summers, *THE UNIFORM COMMERCIAL CODE* § 21-10 at 752-54 (4th ed. 1995) When enacted state rules inform the federal common law, the result under the preemption doctrine should be the same as when section 9-104(1) applies. Under either approach, local law is displaced by the federal scheme but should be consulted where the federal scheme is silent. However, enacted state law will be ignored in formulating federal common law rules when there is a strong overriding interest in national uniformity and otherwise applicable state law varies from the commercial norm. *Id.* In such cases, the "Uniform Version" of Article Nine, rather than the version enacted in the "contact" state, may be the best place to find the supplementing federal common law. *Allen v. F.D.I.C.*, 599 F. Supp. 104 (E.D. Tenn. 1984); *F.D.I.C. v. Morgan*, 727 S.W.2d 500 (Tenn. Ct. App. 1986). The distinction may have limited importance, however, because there is general uniformity with respect to definitions and priority rules among the enacted versions of Article Nine.

¹⁸¹ *Roman Cleanser v. National Acceptance Co.*, 43 B.R. 940, 945 (Bankr. E.D. Mich. 1984), *aff'd*, 802 F.2d 207 (6th Cir. 1986); *In re 199z, Inc.*, 137 B.R. 778, 781-82 (Bankr. C.E. Cal. 1992). See also *In re C.C. & Co.*, 85 B.R. 485, 487 (Bankr. E.D. Va. 1988) ("A indebtedness."). *In re Together Development Corp.*, 227 B.R. 439, 441 (Bankr. D. Mass. 1998); 43 B.R. at 946; 137 B.R. at 781; 85 B.R. at 486-87; *In re Chattanooga Choo-Choo Co.*, 98 B.R. 792, 796 (Bankr. E.D. Tenn. 1989); *In re TR-e Indus.*, 41 B.R. 128, 131 (Bankr. C.D. Calif. 1984); *Li'l Red Barn, Inc. v. Red Barn Systems, Inc.*, 322 F. Supp. 98, 107 (N.D. Ind. 1970).

creatures of state law. Under Article Nine, a trademark is a "general intangible," which normally means that the Secretary of State's Office is the appropriate place to file a security interest.¹⁸²

Because the priority rule under section 1060 of the Lanham Act seems confined to "assignments" and "subsequent purchasers," partial preemption has less support under section 1060 than under section 261 of the Patent Act.¹⁸³ But because the secured party seems to qualify as a section 1060 "subsequent purchaser" that would be protected against delayed or unrecorded assignments, the state law rule in UCC section 9-301(1)(d) would have to yield on this point.¹⁸⁴ Under section 1060, the assignee must record within the three-month grace period, or at least before the security interest attaches. If not, the secured party wins if it gives the debtor new value and has no notice of the prior assignment. Remember that even if it is viewed as a "purchaser" for Lanham Act purposes, the secured party is unprotected against a prior unrecorded assignment of the mark during the three-month grace period in section 1060 as well as throughout the period of any "office delay."¹⁸⁵

V. MODEL LEGAL AND TECHNOLOGICAL SYSTEM STRUCTURE

A. *Model Technological System - Basic Elements and Premise*

1. Background

Government agencies ensure the integrity of secured credit by providing systems for the filing, maintenance and searching of security interests. The overall goal of these systems is to provide a means of sharing information and ordering priority with the aim of helping lenders minimize their credit risks. The Uniform Commercial Code is a set of laws adopted by each state government that facilitates and regulates commercial transactions under a standard set of legal assumptions. A portion of this code, the UCC Article Nine Filing System, establishes the method in which states file,

¹⁸² UCC § 9-106, cmt.; UCC § 9-401(1)(b).

¹⁸³ *Roman Cleanser v. National Acceptance Co.*, 43 B.R. 940, 945 (Bankr. E.D. Mich. 1984), *aff'd* 802 F.2d 207 (6th Cir. 1986).

¹⁸⁴ See THOMAS M. WARD, *INTELLECTUAL PROPERTY IN COMMERCE* § 2:102 (2002).

¹⁸⁵ 15 U.S.C. § 1060 (1988); *Id.*

maintain and search information regarding security interests and other financing activities. [See Appendix 21.]

State filing offices operating within the Article Nine structure have similar recording tasks and objectives but make use of different technologies for carrying out these tasks. A typical first access to the Article Nine system would involve a creditor filing a financing statement (usually form UCC-1) within the state in which the debtor was located. This form describes the transaction including party names, loan amount, terms of repayment, liens against assets, etc. The legal term for registering a security interest in this way is *perfection*. Other activities involve changing information (form UCC-2) and searching (form UCC-3). State recording offices also manage systems for the registration of some state created forms of intellectual property. [See Appendix 22.] Trademarks, service marks and unfixed works of authorship can be registered at the state level.

Assignments and other transfers of patents, trademarks and service marks can be recorded with the federal government through the US Patent and Trademark Office. [See Appendix 23.] As discussed in this report, this federal recording system comes into structural and legal conflict with the state filing system under UCC Article Nine. Since federal intellectual property assets can be used as collateral under a security agreement secured creditors should be able to both: 1) search state and federal records within a single electronic operation and, 2) have a single reliable mode for the “perfection” of security interests in federal intellectual property.

From the lender point-of-view, easy access to security interest information that concerns the debtor’s intellectual property assets, across all states, would help protect them against title defects or lien rights in intellectual property that might diminish its value as collateral. Centralization of this information could be the premise for a notice-based system that would help protect against a later unauthorized transfer of these assets to assignees or subsequent lenders.

Currently, varying levels of automation among the various states hamper efforts to centralize information on security interests. While some states have highly interactive, web-based filing and search systems, others continue to operate paper-based systems. Some of the states, while maintaining electronic databases of filings, provide search services in a non-interactive way. These systems maintain UCC filings in electronic form in databases but users who want to query the system have to file a paper-based request for searches (along with fees). At the state offices, employees then search the system electronically and return search results by mail or fax printouts.

Revised Article 9 requires that all of the 50 states conform to revisions to the UCC by July 1, 2001. While many states are working towards meeting this deadline, not all states are expected to comply with the

deadline due to resource constraints. What follows is a brief description of some of the specific, technology based changes proposed in Revised Article Nine (source: www.intercountyclearance.com):

a) Technology Based Changes in Revised Article Nine

(1) Media Neutrality

Reference to paper as the medium for filing and searching has been removed in Revised Article Nine. The deletion of this reference will lead to conversion from the paper-based systems to electronic filing and retrieving systems though the interactive nature of such electronic systems may vary substantially. That is, while some states may convert to electronic databases for storing UCC filings and amendments, the search process may not be fully interactive, and some other states may implement fully interactive, web-based filing and search systems.

(2) Signatures

The requirement to have wet signatures on financing documents is removed, thus making the process of conversion to electronic databases more feasible. The recent regulations to accept Digital Signatures using encryption technologies can further help in providing security and privacy of data transmission and storage.

(3) Central filing

Dual filing requirement that currently exists in some states will no longer exist, thus leading the way to centralized storage of all filings in each state.

(4) Where to file

The changes require that if a debtor is an organization, then the UCC filing is done at the state of registration. If the debtor is an individual, then the state of legal residence is where UCC filings need to be made.

(5) Standard forms

Forms for filing financial statements (UCC 1) and amendments (UCC 3) are standardized.

b) Possible One-Stop Shop System

The process of performing a thorough background check of a borrower or an asset is currently quite cumbersome. The current system requires significant resources and effort, presents a significant time delay issue, is not automated, is not interactive, allows for the possibility of human error, and results in great expense to the user.

Because of these issues, exhaustive searches, though desirable, are infrequent. It is possible however, to design an automated, “one-stop shop” system that will perform fully exhaustive, multi-state searches that will meet the requirements of Revised Article Nine and quickly and cost effectively present the end user with valued information.

B. Proposed Technological System Solutions

1. Solution Requirements

a) Single point entry for search criteria

A user should be able to specify informational requirements through easy to navigate, user-friendly input screens. Items to select include tangible/intangible asset search and which states to search.

b) Single point electronic payment system

Payment by the user would be made to the centralized agency, irrespective of the individual states searched. Users need only enter payment information (i.e. credit card information) once.

c) Interactivity

The system should prompt the user for selection of appropriate system-generated list of choices. Search results are displayed in summary form with an option to “drill down” for details.

d) Web-based interface

Access to the service should be via the internet using common browser technology (Netscape and Microsoft Internet Explorer).

e) Personalization

A user should have a personalized account with home page and stored personal information. Upon initial account creation, the user's basic information (name, address, phone, email, etc.) along with billing information (credit card or other) are entered. The user need only login with a password to access his account.

f) Security

The system must protect the integrity of the states' stored data from tampering and also from unauthorized viewing.

g) Organized presentation of results/information

Standardized reporting formats for all information enables easy use of the information by the users.

h) Inclusion of all applicable data sites (state and federal)

Reported data must reflect an exhaustive search of relevant sources. A distinction must be made between a database search yielding no results and a lack of results from hardware or connection problems.

C. *Ideal Technological Solution*

From a technological perspective having a central database with one interface would be an ideal solution. This model allows for easy administration of the system—customizability, upgrading, hosting and backup. It would also provide benefits to users through its one-stop, web-accessed, do-all search page and quick, comprehensive search results. States would benefit by eliminating their need to maintain their individual systems. However, the implementation of this solution may not be feasible since it

requires that states give up ownership of their UCC filings database, which is unlikely to happen. [See Appendix 24.]

D. Next Best Solution

To allow states to maintain the independence of their existing systems, this solution builds a composite database at a central location to which the user interface can interact. Information in the composite database is kept current through regular access to state databases and the download of any changes. This solution affords all the benefits of the ideal technological solution from a security interest users point of view without materially changing each state's current practices.¹⁸⁶ From the state's point of view, they continue to own and operate their existing UCC filing databases, but allow the centralized system to periodically copy their data. While this approach does not require states to disown their UCC filing databases, there is still significant challenge in convincing states to allow copying of the data to reside elsewhere. [See Appendix 24.]

E. Proposed Solution

The proposed solution provides users a one-stop search page "portal" accessible via the web, however, all records (and their ownership and control) continue to remain with each state. The proposed system acts as the intermediary - taking users requests, querying appropriate state records and returning results. [See Appendix 24.]

Not requiring each state to give up ownership of their UCC filing database to a centralized system is a significant advantage over the aforementioned alternative solutions (ideal and next-best). In this proposed approach, each state will continue to maintain and operate their UCC filing database. Further, there is not need for the states to allow copies of their UCC filing databases to reside in a centralized system (as in the second-best solution). Therefore, the system architecture proposed in this solution is far superior to the previous two and poses less challenge to implement.

However, in the proposed solution architecture the development of a web-enabled software to drive the server that remotely interacts with the 50 states database engine many not be an easy task. The centralized web server requires a customized CGI script (Common Gateway Interface) program for each state. The CGI script has to be developed and tested for each state. The script program has to interact with the database engine for each state's UCC

¹⁸⁶ Some states do not yet have electronic databases.

filing system, provide the search criteria and receive the search results. The web server should be able to consolidate the search results returned by multiple states and present them to the user's browser via the Internet.

While the task of developing the functionality of remote interaction with state-based UCC filing systems and presenting search results in a standard format via the Internet may be technically challenging, this is very much a feasible approach. The advantage of this approach is that this solution does not require the states to part with full or partial ownership of their databases. Nor does it require states to modify their systems to meet the requirements of a centralized system. The burden of interacting with individual state-based systems lies with the centralized server and this task can be accomplished.

There are two main types of users of this system. First, individuals or groups will be looking to perform infrequent checks on a one-by-one basis. This category of user is characterized as pay-as-you-go, inputting basic information and payment methods each time. The second class of user is more institutional, such as banks, credit unions or other lending agencies. These users would have personalized accounts and sophisticated billing, reporting and other features.

The proposed solution provides the user the flexibility of searching one, all or any combination of states as well as the option to search for intangible asset ownership at the US Patent and Trademark Office. As indicated in the diagram, the heart of the system is one central web-hosted control application. This system maintains real-time contact via the Internet with each of the 50 states' computer systems and also the federal Patent and Trademark Assignment Database at the USPTO. Access to the main system is accomplished through standard web browser technology. Users must first log-in to their account (or create a new one with a valid payment method) before any searching can be done. Authorized users then submit information regarding which company or asset to search in which state or states. The request is carried out "behind the scenes" to the user where information requests are sent to each relevant state, collected and formatted for clean, organized presentation back to the user.

1. Technical Requirement

This solution requires development of a web-enabled software application. Additionally, the software must run on a web server capable of performing the required operations and handling the expected usage volume. Each state must have an electronic database that can be logged onto remotely, either through the web or EDI. By far the greatest challenge to this system is securing and maintaining real-time Internet connections to each of

the states systems. Current state systems use varying levels of technology (from paper-based filing cabinets to fully-functional web-enabled systems) as well as differing technological platforms (UNIX based or Windows based). The successful system will require hardware and software capable of interfacing with each of the independent systems effectively and efficiently.

2. Operational Requirements

States would only be required to continue their current practices of maintaining their own electronic databases. This includes proper entry of data, maintenance and backup. The software application need only be hosted on a web server and would perform the following functions: General Information to site visitors, Registration forms, Login page for registered users, Search forms and Display results. Several issues need to be addressed by the software in order to ensure effectiveness of solution. The software must include an engine which can interact with each state database. Security also needs to be addressed.

3. Usage Charges and Disbursement

Pricing of services made possible through the proposed solution requires further study. Though current attempts to perform exhaustive security interest searches are very costly and time consuming and there are tremendous benefits for having a quick, centralized system, it is unclear what costs the market is willing to pay for such services. Pricing should be flexible and fair. Users should pay for services used and states should be properly compensated for participating. An example pricing scheme is as follows:

10 state search = \$100

25 state search = \$125

50 state search = \$150

Since system maintenance, upkeep and monitoring incur costs, raised revenues are not entirely available for distribution to states. Infrastructure costs for hardware and software systems must be accounted for and should include measures for data backup, security, redundancy and bandwidth. Other costs include operational expenditures such as programming, training and administration. Further research is needed to determine these overall operating costs. At this time, one third (or 33%) of the raised revenues from the system are assumed to be used to cover such operating costs.

Excess revenue will then be distributed to the states. Several methods of distribution are possible:

a) Equal portion to each state

The centralized system collects its usage fees and, less operating costs, could distribute the proceeds equally to each of the fifty United States.

Example:¹⁸⁷ Search all states, fees = \$150

Operating costs: 33% or \$50, States: 67% or \$100

\$100 / 50 states = Each state receives \$2 for this search

Proportional to number of stored records: Since some states are more populous, have more commerce and thus more UCC filings, income generated for the central system could be divided relative to this number of filings.

Example: Search all states, fee = \$150

Operating costs: 33% or \$50, States: 67% or \$100

US records: 100 million, CA record: 25 million (25%)

\$100 * 25% = CA receives \$25 for this search

b) Proportional to number of records returned:

This method of distribution accounts for the activity of business and thus its operating states' UCC system burden. States from which search results come, indicating company activity, are compensated.

Example: Search all states, fee = \$150

Operating costs: 33% or \$50, States: 67% or \$100

Records returned: 5, CA records 2(40%)

\$100 * 40% = CA received \$40 for this search

c) Fixed and variable method

This method of distribution compensates states with a fixed rate for allowing a search upon their databases and a variable rate dependent upon actual records being found upon them.

Example: Search all states, fee = \$150

Operating costs: 33% or \$50, States: 67% or \$100

Fixed component: 40% or \$40, Variable component: 60% or \$60

Records returned: 10, CA records returned: 2(20%)

CA received 1/50th of \$40 plus 20% of \$60 = \$14 for this search

¹⁸⁷ Figures and values used in examples are for illustrative purposes only and are not intended to be recommendations. Further study and due diligence are needed to determine actual costs.

The final method compromises between large states, who have most records and small states, who still need to be searched to attain an “exhaustive” search.

F. Conclusion

The proposed Centralized Security Interest Perfection System (“CSIPS”) provides a better way to perfect security interests and benefits all. It will help to fulfill the purpose of the current UCC and Intellectual Property systems by making their information more accessible and useful. Users of the system will get more complete information in a much shorter period of time, having to access only one source.

To individual states this proposal also makes sense. They will continue to maintain independence and sovereignty over their own information. However, by making their information more accessible, the number of searches are likely to increase thus increasing their revenue stream. Initially, CSIPS is only another avenue of information access. States’ current methods of searching continue to exist. Over time, though, the advantages in time, effort and cost savings are expected to see CSIPS become the dominant if not only method of security interest searching.

The most notable challenge to implementing such a system is the current lack of electronic databases in some states. Though a system can be designed to allow for the later addition of these states, users may have a problem as the search results are not complete. A second challenge is the potential debate regarding the fair sharing of search revenues. A final point to bear in mind is the potential displacement of workers who are currently employed for the purpose of performing manual searches.

VI. RECOMMENDATIONS-ALTERNATIVE LEGISLATIVE MODELS BASED ON RECOMMENDED SYSTEM STRUCTURES

A. Model Acts-Basic Elements and Premises

1. The Problem and the Three Proposed Legislative Solutions

This report offers three alternative approaches to legislative reform contained in three “Model Acts.” Although the three offered solutions differ, they are all aimed at establishing a reliable and economically efficient filing

system for the “perfection” of security interests in federal intellectual property. As discussed in this report, certainty of perfection in these intangible assets is the key to a secured creditor’s ability to hold its priority position against subsequent security interests, subsequent unauthorized transfers and a subsequent bankruptcy trustee of the debtor. The problem with the current legal structure is that the federal recording statutes for federal intellectual property have a title/tract-system premise that does not accommodate the modern secured transaction.¹⁸⁸ Yet these old federal recording statutes, viewed in the context of their history and the history of title-based mortgages, have a degree of preemptive force that has been found, in varying degrees, to displace the modern efficient rules for secured financing in Article Nine of the Uniform Commercial Code. The lower court cases that have found preemptive force in these federal recording statutes are discussed in great detail in PRELIMINARY REPORT # 1.¹⁸⁹ The most significant of these cases are also noted in SECTION 2(a)(4) of each of the three alternative Model Acts. All three Model Acts have three predicate elements in common.

A commitment to the notice filing and perfection structure of Article Nine.

a) The integration of critical Article Nine financing statement information, indexed by the name of the debtor, into the tract-type property number system that is the premise of the federal intellectual property recording statutes.

b) A single unified database or web-based meta-site with access to or ownership of all security interest filings on federal intellectual property under one responsible agency charged with set-up and maintenance.¹⁹⁰ [For a discussion of pending federal reforms See Appendix 24.]

¹⁸⁸ PRELIMINARY REPORT # 1: *supra* note 80 at 1-13. See also Appendix 15 and Appendix 20

¹⁸⁹ PRELIMINARY REPORT # 1, *supra* note 80 at 97-119, 136-144, 156-163.

¹⁹⁰ See Chapter V., MODEL LEGAL AND TECHNOLOGICAL SYSTEM STRUCTURE, *supra* at 60-66. The systems recommended in Chapter V. could be used to centralize all filed information on security interests. The Model Acts contained herein call for more specific handling of those financing statements and related filings that are designated by the secured party as covering the debtor’s “general intangibles.” Financing statements used to provide notice on specific goods (e.g., purchase money filings and equipment leases) need not be included within this integrated web-based system.

2. Notice Filing

This report concludes that any viable solution must begin by recognizing the long term value of the Article Nine notice filing model for dealing with security interests in all forms of intellectual property and by restoring this model to the center of the legal structures for dealing with federal intellectual property collateral. Although the operative language is modified slightly, all three of the Model Acts follow the suggestion of the ABA Joint Task Force on Security Interests in Intellectual Property and remove security interests altogether from the existing federal tract files.¹⁹¹

3. Integration of Financing Statement Information

For the protection of those who rely on the current property number-based recording system for federal intellectual property rights all three models also call for the establishment of an integrated electronic financing statement database or web-based meta-site. This centralized point of access will bring together state UCC notice filings made available in an electronic format and integrate this data with the grantor and grantee information already contained in the federal tract records. This integration will make it possible to efficiently search UCC filings on grantors and grantees of record who show up under the various federal property numbers.¹⁹²

4. A Single Database or Web-Based Meta-Site Under a Single Agency

In his testimony before the House Subcommittee on Courts and Intellectual Property on June 24, 1999, Q. Todd Dickinson suggested to the Congress that a single unified database to gather and maintain security

¹⁹¹ All three models go beyond the ABA language by removing the priority provision for security interests from the proposed amendment to section 1060 of the Lanham Act and adding language which makes clear that security interests are outside the section 1060(a) priority rule for assignments. PRELIMINARY REPORT # 1, *supra* note 80 at 183-185.

¹⁹² Searchers in the tract records need not worry about the notice filings of secured parties whose debtors do not show in the federal title records. [In this context "title records" is read broadly to include some grantee information maintained by the USPTO that is outside the current tract assignment file. In the case of a patent, the first assignee is often noted on the face of the patent itself.]. Under SECTION 3(b)(2) of each Model Act only those secured parties whose debtors can hold their title priority in Federal Intellectual Property Rights against subsequent transferees will prevail against those same subsequent transferees.

interest information on all forms of Federal Intellectual Property would be more efficient than separate databases in the Copyright Office, the U.S.P.T.O. and the Plant Variety Protection Office.¹⁹³ Our study confirms the wisdom of this suggestion. The Model Acts create a Federal Intellectual Property Data Center (or Filing Center in the case of Model 3) charged with setting up and maintaining a central clearinghouse for state financing statements and related filings that are designated as covering the debtor's "general intangibles."

B. Model Acts-Three Different Levels of Federal Involvement in Perfection and Priority

The Model Acts differ in the degree to which they call for federal involvement in an integrated notice filing structure for security interests in federal intellectual property. The basic skeletal differences among these three legislative options is outlined below. Section C, *infra* will examine other structural legal problems addressed by each Model Act.

1. Model 1

Model 1 is called the "Security Interests in Intellectual Property Restoration Act" ("SIIPRA"). [See Appendix 3.] Model 1 overrules the lower court cases on preemption and puts all issues of perfection and priority back under the state law in Article Nine—except for one narrow provision that protects the federal derivative title principle.¹⁹⁴ This Model establishes a Federal Intellectual Property Data Center that puts all electronically available financing statements records at a central search point to aid federal tract file searches. However, under Model 1 (unlike Models 2 & 3) the Data Center is provided only as a convenience to those who use the federal tract records because secured party priority and perfection is basically linked to the

¹⁹³ Oversight Hearings on Intellectual Property Security Registration Before the Subcomm. on Courts and Intellectual Property of the House Comm. on the Judiciary, 106th Cong., 1st Sess. (June 24, 1999) (Statement of Q. Todd Dickinson, Acting Assistant Secretary of Commerce and Acting Commissioner of Patents and Trademarks).

¹⁹⁴ SIIPRA, § 3(b)(2)(B) [Appendix 3]:

(B) A security interest in any Federal Intellectual Property Right created by a specific debtor is subordinate to the rights of an ownership transferee of such Right whenever such ownership transferee has priority over that specific debtor under the applicable federal law on recording and priority that governs such Federal Intellectual Property Right.

applicable state law in Article Nine and the secured party's actual state law notice filing.¹⁹⁵

2. Model 2

Model 2 is called the "Intellectual Property Security Interest Coordination Act" ("IPSICA"). [See Appendix 2.] This Model calls for the creation of a database or meta-site within a new Federal Intellectual Property Data Center. However, under Model 2 the database of state financing statements is central to a new federal subordination rule designed to protect "ownership transferees" who rely on the federal tract records. Unlike the ABA Task Force proposal, Model 2 has no provision for a federal financing statement. Instead, Model 2 relies on the fact that state financing statements are available in electronic record form in most states and should be universally available within the next 2 years. States that allow a simple check or mark designation on their forms to indicate that they cover "general intangibles" can qualify state filed financing statements for central national access within the new Data Center.¹⁹⁶ The incentive for states to make possible this simple designation on their financing statements comes from the fact that effective "posting" of these "qualified" state financing statements to the data center is made essential to a secured party's priority position vis-à-vis federal "ownership transferees." An indicated claim to any of the debtor's "general intangibles" (not just the debtor's federal intellectual property) triggers the designation because the "proceeds" definition in Revised Article Nine (as incorporated in the Model Acts) is broadly drawn to allow security interests in state law forms of intellectual property to carry over into federal forms of protection.¹⁹⁷

With respect to perfection and priority, Model 2 starts in the same place as Model 1 by overturning the preemption cases and restoring the state law in Article Nine to all perfection and priority disputes involving the bankruptcy trustee and other claimants, including other secured parties. But unlike Model 1, Model 2 provides bona fide purchaser ownership transferees with a critical but narrow federal basis for trumping the state law priority that could otherwise be established by the secured party under Article Nine.

¹⁹⁵ Searchers in the tract records need not worry about the notice filings of secured parties whose debtors do not show up in the tract file. Under SECTION 3(b)(2) of each Model Act only those secured parties whose debtors can hold their title priority against subsequent transferees in the tract file will prevail those same subsequent transferees.

¹⁹⁶ IPSICA, § 3(a)(9) & 3(f) [Appendix 2].

¹⁹⁷ U.C.C. [Revised] § 9-102(a)(64)(C); IPSICA, § 3(a)(16) [Appendix 2] See PRELIMINARY REPORT # 80, *supra* note 1 at 58-60.

Under SECTION 3(b)(2)(B), the transferee of a “Federal Intellectual Property Right” can subordinate the secured party by taking an executed transfer for value, without knowledge of the security interest, and before the secured party’s financing statement is “posted” in the new “Federal Intellectual Property Data Center.”¹⁹⁸ The transferee’s right to subordinate comes with a subsequent obligation to record in the appropriate tract file. To hold its right to subordinate, the ownership transferee must record in the applicable tract file within ten days of the date of its executed transfer or, if that grace period has already run, before the competing financing statement is posted within the Federal Intellectual Property Data Center.¹⁹⁹ SECTION 3(b)(2)(D) provides that this subordination rule only cuts in favor of the federal ownership transferee, however. The secured party that avoids subordination must still find its priority under the applicable state law in Article Nine. Take, for example, the case of a secured party that avoids federal subordination because the ownership transferee failed to record its transfer within the ten-day grace period and then after the grace period ran failed to record before the posting of the secured party’s financing statement. Such a secured party will still lose to the federal ownership transferee if the transferee took for value and without knowledge, and the security interest was not “perfected” on the transfer date by a proper filing under applicable state law.²⁰⁰ Furthermore, the ownership transferee gets some added protection from language in SECTION 3(b)(2)(C) that protects the transferee’s title against any secured party who claims through a debtor whose title can be avoided by the ownership transferee.²⁰¹

3. Model 3

Model 3 is called the “Intellectual Property Collateral Coordination Act”: [IPCCA]. [See Appendix 1.] The only difference between Model 2 and Model 3 is that Model 3 provides for a federal financing statement similar to the one proposed by the ABA Joint Task Force that can be filed directly with the Federal Intellectual Property Filing Center - but only as an alternative to

¹⁹⁸ The timing aspect of this subordination rule is patterned after the priority rule for buyers of intangibles in Revised Article Nine. See U.C.C. [Revised] § 9-317(d). The condition subsequent of a recording in the federal tract records is added by the language of this Model Act. IPSICA, § 3(b)(2)(B) [Appendix 2].

¹⁹⁹ IPSICA, § 3(b)(2)(B) [Appendix 2]. This “subordination” rule departs from the “ineffectiveness” rule proposed by the ABA Task Force in FIPSA. See the critique of the FIPSA provision in PRELIMINARY REPORT # 1, *supra* note 80 at 185.

²⁰⁰ U.C.C. [Revised] § 9-317(d). See also U.C.C. § 9-301(1)(d) (1995 Official Version).

²⁰¹ See *supra* notes 194 & 195.

the posting of a “Qualified State Financing Statement.” Hopefully, the federal financing statement will only be a short term redundancy. As state files move toward universal and uniform electronic records the federal financing statement provided for in Model 3 should gradually decrease in importance and disappear.

C. Model Acts - Other Problems and Provisions for Cure

1. Reform of the Priority Rules for Transferees using the Federal Tract Files

In addition to removing security interests from the class of recordable transactions under the federal tract recording statutes, all three Model Acts adopt the language proposed by the ABA Joint Task Force that eliminates or sharply curtails the grace periods in these statutes. All three Model Acts repeal the one or two-month grace period for recording in section 205(d) of the Copyright Act. In its place all three Model Acts creates a race-notice rule that gives priority to the first “executed” transfer of copyright ownership if recorded in a manner to give constructive notice “before recordation in such manner of the later transfer.”²⁰² “Otherwise the later transfer prevails if recorded first in such manner, and if taken in good faith, for value, and without notice of the earlier transfer.”²⁰³ In a similar fashion, all three Model Acts amend the Semiconductor Chip Act by eliminating the three-month grace period for the first executed transfer along with the priority rule that included it.²⁰⁴ Section 1060 of the Lanham Act is also amended by replacing the current three-month grace period for trademark recordings with a straight notice-recording priority rule protecting bona fide purchaser “subsequent purchasers” against unrecorded assignments whether or not they record.²⁰⁵ Unlike the ABA Joint Task Force proposal, however, security interests get no priority shelter under the new 1060 priority rule in the Model Acts.²⁰⁶ A secured party that avoids “subordination” to the

²⁰² SIIPRA, SECTION 4(a)(2) [Appendix 3]; IPSICA, SECTION 4(a)(2) [Appendix 2]; IPCCA, SECTION 4(a)(2) [Appendix 1].

²⁰³ *Id.*

²⁰⁴ SIIPRA, SECTION 4(b) [Appendix 3]; IPSICA, SECTION 4(b) [Appendix 2]; IPCCA, SECTION 4(b) [Appendix 1].

²⁰⁵ SIIPRA, SECTION 4(a)(2) [Appendix 3]; IPSICA, SECTION 4(a)(2) [Appendix 2]; IPCCA, SECTION 4(a)(2) [Appendix 1].

²⁰⁶ PRELIMINARY REPORT # 1, *supra* note 80 at 183-185.

ownership transferee of a Federal mark must still look to state law for perfection and priority.²⁰⁷ The amendment to section 261 of the Patent Act under all three Model Acts reduces the grace period for recording a prior "assignment, grant or conveyance" down from three months to ten days.²⁰⁸

2. The Federal Transfer Statement

Each of the Model Acts make express provision for the recording of a "transfer statement," in the appropriate federal tract file, on property subject to a security interest that is foreclosed on after default.²⁰⁹ If the transfer statement contains the required information and statements and is otherwise proper under the appropriate federal requirement, it is effective as a transfer document between the parties and it transfers the interests of the debtor and the secured party "for purposes of the public record."²¹⁰

The transfer statement provided for in Revised Article Nine served as a pattern for the one provided in the Model Acts.²¹¹ The federal transfer statement will clearly expedite the recordation of post-default transfers of Federal Intellectual Property Rights to third party buyers. The transfer statement in the three Model Acts differs in three respects from the one proposed by the ABA Joint Task Force.

Under the ABA Joint Task Force proposal the transfer statement was effective "for purposes of the public record"²¹² but it was not clear whether the recorded transfer statement obviated the need for an actual document of transfer signed by the debtor in compliance with the formal writing requirements in the existing federal intellectual property statutes.²¹³ The

²⁰⁷ SIIPRA, SECTION 3(b)(2)(C) [Appendix 3]; IPSICA, SECTION 3(b)(2)(D) [Appendix 2]; IPCCA, SECTION 3(b)(2)(D) [Appendix 1].

²⁰⁸ SIIPRA, SECTION 4(c) [Appendix 3]; IPSICA, SECTION 4(c) [Appendix 2]; IPCCA, SECTION 4(c) [Appendix 1].

²⁰⁹ SIIPRA, SECTION 3(c) [Appendix 3]; IPSICA, SECTION 3(c) [Appendix 2]; IPCCA, SECTION 3(c)(2)(G) [Appendix 1].

²¹⁰ *Id.*

²¹¹ U.C.C. [Revised] § 9-617.

²¹² PRELIMINARY REPORT # 1, *supra* note 80 at 185-187.

²¹³ 15 U.S.C. § 1060(a) ("Assignments shall be by instruments in writing duly executed."); 17 U.S.C. § 204(a) (1994) ("A transfer of copyright ownership, other than by operation of law, is not valid unless an instrument of conveyance, or a note or memorandum of the transfer, is in writing and signed by the owner of the rights conveyed or such owner's duly authorized agent."); 35 U.S.C. § 261, 2d para. ("Applications for patent, patents, or other interests therein, shall be assignable in law by an instrument in writing."); 17 U.S.C. § 903(b)(1994) ("The owner of the exclusive rights in a mask work may transfer

Model Acts make the duly recorded transfer statement “serve as an effective document of transfer to the transferee,” and, in addition, make the recorded statement “effective for purposes of the public record.”²¹⁴

The Model Acts prohibit the filing of a transfer statement against debtor’s “intent to use applications,” unless the transfer is to a successor in interest under section 1051(b) of the Lanham Act. Transfer statements filed in violation of this prohibition are ineffective.²¹⁵ While the taking of a security interest in an intent to use application is not “trafficking” in marks,²¹⁶ a transfer statement purports to have the effect of a recorded assignment and would constitute “trafficking.”

Because “goodwill” refers to state law collateral rights, the assets that compose it should not be deemed transferred under a federal transfer statement. The Model Acts delete the language of the ABA Joint Task Force proposal that makes the recorded transfer statement effective to transfer the goodwill of the connected enterprise. All three Model Acts provide that the transfer statement must state that the secured party had a security interest in the connected goodwill of the business whenever Federal marks are included in the statement.²¹⁷ However, the recorded transfer statement itself has no effect on the state law collateral rights that fall within the ambit of “goodwill.”

all of those rights, or license all or less than all of those rights, by any written instrument signed by such owner or a duly authorized agent of the owner.”).

²¹⁴ SIIPRA, SECTION 3(c) [Appendix 3]; IPSICA, SECTION 3(c) [Appendix 2]; IPCCA, SECTION 3(c)(2)(G) [Appendix 1].

²¹⁵ *Id.*

²¹⁶ *Clorox Co. v. Chemical Bank*, 40 U.S.P.Q.2d 1098, 1101 n.10 (TTAB 1996)(A security interest is in the nature of a contingent assignment and is an effective non-title bearing security device when used in connection with an intent to use application).

²¹⁷ SIIPRA, SECTION 3(c)(v) [Appendix 3]; IPSICA, SECTION 3(c)(v) [Appendix 2]; IPCCA, SECTION 3(c)(2)(G)(v) [Appendix 1].

**APPENDIX 1 - INTELLECTUAL PROPERTY COLLATERAL COORDINATION
ACT**

**INTELLECTUAL PROPERTY COLLATERAL
COORDINATION ACT**

106th Congress; 1st Session

In the [House of Representatives/Senate]

[H.R/S.] No. _____

SYNOPSIS:

AN ACT to coordinate the current federal tract recording systems covering federal intellectual property title with the existing and developing state filing systems for perfecting security interests in intangible personal property and to create for that purpose a central notice filing database that will facilitate the efficient and productive use of federal intellectual property as collateral.

DATE OF INTRODUCTION: _____, 2001

SPONSORS: [_____]

TEXT:

Be it enacted by the Senate and House of Representatives of
the United States of America in Congress assembled:

SECTION 1. SHORT TITLE.

This Act may be cited as the “Intellectual Property Collateral Coordination
Act.”

SECTION 2. FINDINGS AND PURPOSES.**(a) Findings**

Congress finds the following:

(1) Enterprises of all size must be able to finance their business activities by obtaining secured credit. Secured financing is often critical to the research and development that leads to the creation of intellectual property. The more secure and predictable the lender's rights and security are, the better terms the borrower can obtain. Conversely, the risk of loss, subordination, impairment or other uncertainties with respect to collateral inhibit the financing desired by all parties. Predictability and uniformity of treatment with respect to intellectual property collateral further the interests of all parties involved in related commercial transactions whether those parties are intellectual property owners, licensees, or their lenders.

(2) In many cases, a company's intellectual property is among the assets most valuable and useful as collateral in obtaining desired financing. Increasingly, companies' assets and entrepreneurial energies are focused on a combination of various forms of intellectual property, and the same product or process may involve a combination of patents, copyrights, trademarks, trade secrets and other intellectual property. Moreover, these intellectual property assets may be protected under the laws of other nations and prospective financiers of these assets may be located outside the United States.

(3) The law governing security interests in all forms of personal property (including intangible forms) has historically been state law. Article 9 of the Uniform Commercial Code, as recently revised, provides a uniform structure for this law between and among the various states. However, the most important forms of intangible intellectual property are either created or enhanced by federal statutory provisions that provide their own recording systems for tracking title and ownership rights in this property. Courts have struggled with the question of whether and to what extent these somewhat dated federal recording statutes should displace the generally well-conceived state law structure (Article 9) when the rights of secured parties in federal intellectual property are at stake. The federal tract recording statutes embrace security interests only as a form or variant of title to specific items of property recorded under specific property numbers.

Furthermore these federal recording provisions vary depending on whether the intellectual property is patents, copyrights or trademarks.

(4) Some federal lower court decisions have held that the only way to perfect a security interest in a copyright, in material that is copyrightable, or in proceeds of such material is to file the equivalent of a copyright mortgage with the U.S. Copyright Office. These decisions include *In re Peregrine Entertainment Ltd.*, 116 B.R. 194 (C.D. Cal.1990); *In re AEG Acquisition Corp.*, 127 B.R. 34 (Bankr. C.D. Cal. 1991), amended 161 B.R. 50 (9th Cir. BAP 1993); and *In re Avalon Software, Inc.*, 209 B.R. 517 (Bankr. D. Ariz. 1997). In something of a retreat from this position, one recent bankruptcy court decision has concluded that federal recording of a security interest in a copyright is necessary only where the copyright is registered. *In re World Auxiliary Power Co.*, 244 B.R. 149 (Bankr. N.D. Calif. 1999).

The cases involving patent collateral have generally upheld secured party lien perfection through state notice filings (Article 9) against the bankruptcy trustee - but have uniformly suggested that the same financing secured party must make a federal assignment filing with the USPTO to be protected against later assignees or mortgagees who take and record patent title instruments. See *In re Cybernetic Services, Inc.*, 239 B.R. 917, 920 at n.8 (9th Cir. B.A.P. 1999). See also *City Bank and Trust Co. v. Otto Fabric, Inc.*, 83 B.R. 780, 782 (D. Kan. 1988), relying on, *In re Transportation Design and Technology, Inc.*, 48 B.R. 635, 639, 40 UCC 1393, 1398 (Bankr. S.D. Cal. 1985).

The cases involving trademark collateral have found state law (Article 9) filing sufficient notice. However, this state law notice has not been tested in the cases against an assignee of a mark who relies exclusively on the federal assignment record. See *Roman Cleanser v. National Acceptance Co.*, 43 B.R. 940, 945 (Bankr. E.D. Mich. 1984), *aff'd*, 802 F.2d 207 (6th Cir. 1986); *In re 199Z, Inc.*, 137 B.R. 778, 781-82 (Bankr. C.D. Cal. 1992). See also *In re C.C. & Co.*, 85 B.R. 485, 487 (Bankr. E.D. Va. 1988) ("A grant of a security interest is merely a device to secure indebtedness.")

(5) Because they are tract type systems that rely on specific assigned property numbers, the federal systems for registering interests in intellectual property, unlike the Article 9-based state filing systems, do not provide for notice filing under the debtor's name, for generic descriptions of collateral, or for perfection of security interests in

subsequently-acquired property. As a result of the structural rigidity of the current federal recording provisions, companies seeking financing and their lenders have either had to incur the time and expense of additional and frequent recordings and registrations that would not otherwise have been made, or forego financing opportunities.

(6) This Act makes substantive and procedural changes to the law in order to provide uniformity and certainty and to facilitate financing of federal intellectual property, consistent with the rights of owners and assignees of interests in such property.

(b) Purposes

Based upon the powers contained in Article I, Section 8, Clause 3; Article I, Section 8, Clause 8 and other provisions of the Constitution of the United States, the purposes of this Act are:

(1) To promote financing and development of federal intellectual property assets by clarifying the methods for perfecting security interests in such collateral, and by making all forms of intellectual property collateral as accessible, valuable and useful as possible;

(2) To assist businesses (and, through them, consumers and others) in obtaining credit on the best available terms; and

(3) To lessen the burdens on interstate commerce and commerce between the United States and other nations by reducing legal risks associated with the inconsistent treatment of different types of federal intellectual property.

(4) To provide an accessible integrated national filing system built around an integrated database for all security interests that cover this important federal statutory property and to enable future international access to and integration with this system and database.

SECTION 3. SECURITY INTERESTS IN INTELLECTUAL PROPERTY SUBJECT TO FEDERAL LAW

(a) Definitions

The following definitions shall apply for purposes of this Act:

(1) The term “copyright” means any of the exclusive rights comprised in a copyright under chapter 1 of title 17, United States Code, whether or not registered under chapter 4 of such title.

(2) The phrase “encumbering financing statement” means either a qualified state financing statement or a federal financing statement that is filed in the name of an entity that is or was an immediate ownership transferor of a Federal Intellectual Property Right.

(3) A “federal financing statement” means a notice of a security interest which complies with the requirements of § 3(c) of this Act and is filed directly with the Federal Intellectual Property Filing Center created under § 3(d). Unless the context otherwise requires, the term “federal financing statement” includes the original federal financing statement and any filed amendments, continuations and assignments.

(4) The “Federal Intellectual Property Filing Center” refers to the office formed within the Department of Commerce under § 3(d) of this Act that is charged with the creation and maintenance of the file and associated records for federal financing statements filed with the Center and for qualified state financing statements posted within the National Integrated Financing Statement Database.

(5) The term “Federal Intellectual Property Rights” means copyrights, patents, Federal marks, mask works, plant variety protection rights and vessel hull design protection rights.

(6) The term “Federal mark” means a mark that is registered pursuant to the Lanham Act (15 U.S.C. §1051 et seq.), or for which an application for such registration is pending with the U.S. Patent and Trademark Office.

(7) An “immediate ownership transferor” means a person who transfers directly to an ownership transferee any right or interest (other than a security interest) in, or ownership of, a Federal Intellectual Property Right.

(8) The term “mark” has the meaning given in section 45 of the Lanham Act (15 U.S.C. §1127).

(9) The term “mask work” has the meaning given in section 901 of title 17, United States Code.

(10) An “ownership transferee” means a person other than a secured party or lien creditor who acquires any right or interest (other than a security interest) in, or ownership of, a Federal Intellectual Property Right.

(11) A “qualified state financing statement” means a financing statement that: (1) complies with the requirements for filing in the state where filing occurs, (2) contains a description of collateral that would be sufficient to cover the debtor’s Federal Intellectual Property Rights under § 3(c)(1)(B) if the financing statement were a federal financing statement, (3) is designated as such and made electronically available by the filing state to the National Integrated Financing Statement Database as provided in § 3(f). Unless the context otherwise requires, the term “qualified state financing statement” includes the original federal financing statement and any filed amendments, continuations and assignments.

(12) The term “patent” means a patent or a pending application for a patent under title 35, United States Code.

(13) The term “plant variety protection rights” means a certificate of plant variety protection or a pending application for such a certificate under chapter 57 of title 7, United States Code.

(14) The term “person” means an individual, corporation, partnership, limited liability company, business trust, estate, trust, association, joint venture, government or governmental subdivision or agency, or any other legal or commercial entity.

(15) The term “posting” with respect to an encumbering financing statement refers either to (1) the time when a federal financing statement is filed with the Federal Intellectual Property Filing Center, or (2) the time when a qualified state financing statement is made accessible [by internet link or other electronic means] within the National Integrated Financing Statement Database provided for in § 3(e).

(16) The term “proceeds” means: (i) whatever is received or to be received by the owner or any other party from the transfer, disposition, license (whether or not exclusive), use or other exploitation of Federal Intellectual Property Rights, (ii) whatever rights arise out of or are derived from Federal Intellectual Property Rights, and (iii) whatever would be included within the definition of “proceeds” under the applicable non-federal law relating to security interests in personal property.

(17) The term “state” refers to the states of the United States and to all possessions and territories of the United States.

(18) The term “vessel hull design protection rights” means a certificate of registration or a pending application for such a certificate under chapter 13 of title 17, United States Code.

(19) Unless otherwise provided by this Act, the terms “authenticate”, “collateral”, “debtor”, “financing statement”, “good faith”, “general intangible”, “lien creditor”, “knowledge”, “notice”, “representative” “secured party”, “security agreement”, “security interest”, “signed” or “signature” and “value” shall have the meanings given to such terms under applicable non-federal law relating to security interests in personal property.

(b) Security Interests

(1) This section applies to all security interests in Federal Intellectual Property Rights and in the proceeds thereof which interests are created by contract, regardless of form and nomenclature.

(2) (A) The creation, attachment, perfection, effect of perfection, priority and enforcement of a security interest in a Federal Intellectual Property Right or in the proceeds thereof relative to all competing rights, claims, and interests therein and licenses thereof shall be determined by applicable non-federal law governing security interests in personal property, except as provided in subsections (b)(2)(B) and (b)(2)(C). The creation, attachment, perfection, effect of perfection, priority and enforcement of any right or interest (other than a security interest) in, or ownership of, a Federal Intellectual Property Right shall be determined by the applicable federal law governing such Federal Intellectual Property Right.

(B) A security interest in a Federal Intellectual Property Right is subordinate to the rights of an ownership transferee who gives value without knowledge of the security interest, if (i) the document transferring ownership of the Federal Intellectual Property Right to the ownership transferee is executed before the posting of an encumbering financing statement covering the Federal Intellectual Property Right and (ii) such ownership transferee makes an effective recordation of the document transferring ownership in the manner required under applicable federal law (as amended by Section 4 of this Act) to give priority to such transferee - (a) within 10 days of the execution date of the document of transfer, or - (b)

before the posting of such encumbering financing statement. [The rule in this subsection does not displace otherwise applicable non-federal law until the effective date provided in § 6(a).]

(C) A security interest in any Federal Intellectual Property Right created by a specific debtor is subordinate to the rights of an ownership transferee of such Right who takes from the same immediate ownership transferor as the debtor whenever such ownership transferee has priority over that specific debtor under the applicable federal law on recording and priority that governs such Federal Intellectual Property Right.

(D) A security interest in a Federal Intellectual Property Right that has not been made subordinate under either of the two preceding subsections has priority over such ownership transferee of such Right if and to the extent that such security interest meets the requirements for priority as provided under applicable non-federal law governing security interests in personal property.

(c) Federal Financing Statements and Transfer Statements

(1) (A) A federal financing statement may be filed by a secured party or by the debtor to give notice of the secured party's interest in the Federal Intellectual Property Rights described in the statement. The federal financing statement shall contain the names of the debtor and the secured party (or its collateral agent or trustee); the mailing addresses of the debtor and the secured party; and a description, which may be general, specific or both, indicating the types, or describing the items, of collateral.

(B) In describing the collateral in a federal financing statement, a general reference to "intellectual property" or "general intangibles" shall be sufficient to describe all of the debtor's interests in all Federal Intellectual Property Rights, including those Federal Intellectual Property Rights subsequently created or acquired. A general reference to "marks", "patents," "copyrights" or "mask works" shall be sufficient to describe all of the debtor's interests in the respective sub-category of Federal Intellectual Property Rights, including such of those Federal Intellectual Property Rights subsequently created or acquired.

(C) A federal financing statement may be filed at any time, whether before or after a security agreement is entered into or a security interest otherwise attaches, before or after a financing statement is

filed in a non-federal jurisdiction, or before or after a Federal Intellectual Property Right is created or a Federal Intellectual Property Right is acquired by the debtor.

(D) A secured party of record in a federal financing statement may add or delete Federal Intellectual Property Rights as collateral or otherwise amend the information provided in a federal financing statement by filing an amendment that describes the changed information and identifies, by file number, the original federal financing statement to which the amendment relates. An amendment does not extend the period of effectiveness of a federal financing statement. If any amendment adds collateral, it is effective as to the added collateral only from the filing date of the amendment.

(E) A federal financing statement sufficiently provides the name of the debtor only if it provides the individual, partnership, corporate, or other entity name of the debtor, whether or not it adds trade names or names of partners. Where the debtor so changes the debtor's name, identity, or corporate structure that a filed federal financing statement becomes seriously misleading, that federal financing statement is not effective with respect to Federal Intellectual Property Rights collateral acquired by the debtor more than four months after the change [plus the period of the filing backlog at the applicable Federal agency at the time of such change], unless a new federal financing statement or an amendment which renders the federal financing statement not seriously misleading is filed before the expiration of that time. A filed federal financing statement remains effective with respect to Federal Intellectual Property Rights described therein that are sold, exchanged, licensed or otherwise transferred and as to which the secured party's security interest continues, even if the secured party knows of or consents to the disposition.

(F) A federal financing statement substantially complying with the requirements of this subsection is effective even if it contains minor errors or omissions as long as such errors or omissions are not seriously misleading.

(2) (A) (i) Presentation for filing of a federal financing statement and tender of the filing fee or acceptance of the federal financing statement by the Federal Intellectual Property Filing Center constitutes filing of the federal financing statement under this subsection 3(b).

(ii) The Federal Intellectual Property Filing Center shall assign to each federal financing statement a file number and keep a record of the date and hour of filing, and shall hold the statement or other reliable record thereof for public inspection. The Federal Intellectual Property Filing Center shall index the federal financing statement according to the name of the debtor and shall note in the index the file number and the name and address of the debtor and the secured party given in the statement.

(B) A filed federal financing statement is effective for ten years from the date of filing. The effectiveness of a filed federal financing statement lapses on the expiration of the ten-year period unless a continuation statement is filed prior to the lapse.

(C) (i) An assignment statement may be filed by the secured party of record or its assignee to disclose an assignment of a security interest in some or all of the collateral described in a filed federal financing statement. The assignment statement must be authenticated by the secured party of record, must indicate the name and address of the assignee and the file number of the original federal financing statement, and must describe the types or items of collateral covered by the assignment. On presentation of the assignment statement to the Federal Intellectual Property Filing Center, the Center shall note the hour and date of filing of the assignment statement upon the record of the original federal financing statement.

(ii) After the filing of an assignment statement under this Section, the assignee is the secured party of record with respect to the Federal Intellectual Property Rights collateral covered by the assignment statement.

(D) A continuation statement may be filed within six months prior to the expiration of the ten-year period specified in subsection (c)(2)(B). Any such continuation statement must be filed by the secured party of record or its assignee, and identify by file number the original federal financing statement. A continuation statement filed by a person other than the secured party of record must be accompanied by a separate assignment statement authenticated by the secured party of record and complying with subsection (c)(2)(C), including payment of any required fee. Upon timely filing of the continuation statement, the effectiveness of the original federal financing statement is continued for ten years after the last date to which the filing was theretofore effective, whereupon it lapses in the

same manner as provided in subsection (c)(2)(B) unless another continuation statement is filed prior to such lapse. Succeeding continuation statements may be filed in the same manner to continue the effectiveness of the original federal financing statement.

(E) Whenever there is no outstanding secured obligation and the secured party of record is not subject to any commitment to make advances to the debtor, incur obligations or otherwise give value, the secured party must, within 10 days after written demand by the debtor, send to the debtor or file with the Federal Intellectual Property Filing Center a termination statement to the effect that the secured party no longer claims a security interest under the federal financing statement. A termination statement authenticated by a person other than the secured party of record must be accompanied by a separate written assignment statement authenticated by the secured party of record and complying with subsection (c)(2)(C), including payment of the required fee. Upon the filing of a termination statement with the Federal Intellectual Property Filing Center in accordance with this paragraph, the federal financing statement to which the termination statement relates ceases to be effective.

(F) A secured party of record may by a release statement release all or part of any Federal Intellectual Property Rights collateral described in a filed federal financing statement. A release statement is sufficient if it contains a description of the types or items of the collateral being released, the name and address of the debtor, the name and address of the secured party, and the file number of the federal financing statement. A release statement authenticated by a person other than the secured party of record must be accompanied by a separate assignment statement authenticated by the secured party of record and complying with subsection (c)(2)(C), including payment of the required fee. Upon presentation of such a release statement to the Federal Intellectual Property Filing Center, such office shall note the hour and date of filing of the release statement upon the record of the original federal financing statement.

(G) With respect to any Federal Intellectual Property Rights that are subject to a security interest (whether or not perfected) as to which the secured party has exercised its post-default rights or remedies, the person that is the transferee of such Federal Intellectual Property Rights as a result of such exercise of rights or remedies may file in the appropriate Federal record a transfer statement that:

(i) states the name of the debtor and the name and mailing address of the secured party;

(ii) identifies the Federal Intellectual Property Rights transferred;

(iii) identifies, by file number either: (1) the federal financing statement previously filed in the Federal Intellectual Property Filing Center by the secured party covering the Federal Intellectual Property Rights, or (2) the qualified state financing statement previously filed by the secured party covering Federal Intellectual Property Rights that is posted in the National Integrated Financing Statement Database.

(iv) states the name and mailing address of the transferee of the Federal Intellectual Property Rights (which may but need not be the secured party); and

(v) states that: (a) the secured party had a security interest in the Federal Intellectual Property Rights (and, in the case of Federal marks, in the goodwill of the business connected with the use of and symbolized by such Federal marks); (b) the debtor defaulted in connection with an obligation secured by the Federal Intellectual Property Rights and such default has not been cured; (c) the debtor has been given at least 5 days prior written notice of the transfer (which notice shall be deemed given if the secured party shall have complied with the notice requirements of applicable non-federal law in connection with the foreclosure upon, or other disposition of, collateral other than such Federal Intellectual Property Rights); and (d) the identified transferee of the Federal Intellectual Property Rights has complied with all requirements imposed by federal law as a condition to the effectiveness of a transfer of such Federal Intellectual Property Right and is entitled to the transfer of record of the interest of the debtor in the Federal Intellectual Property Rights transferred by reason of the secured party's exercise of its post-default rights or remedies in accordance with applicable non-federal law. A transfer statement that identifies an intent to use application under 15 U.S.C. § 1051(b) among the Federal Intellectual Property Rights transferred may not be filed or recorded under this section unless the transferee is a successor to the business of the applicant within the meaning of 15 U.S.C. § 1060(a). A transfer statement filed or recorded in violation of such prohibition shall have no force or effect on any of the Federal Intellectual Property Rights identified therein.

Recordation by a transferee of such a transfer statement in the appropriate federal record and in the manner required under applicable federal law (as amended by Section 4 of this Act) to give priority to such transferee's interest in the Federal Intellectual Property Right shall, if the transferee has complied with all other requirements imposed by federal law as a condition to the effectiveness of a transfer of such Federal Intellectual Property Right, serve as an effective document of transfer to the identified transferee, of the interest of the debtor and the secured party in the Federal Intellectual Property Rights transferred. Such recordation of the transfer statement shall also be effective for all public record purposes under the appropriate federal recording requirement.

The Register of Copyrights, subject to the approval of the Librarian of Congress, the Commissioner of Patents and Trademarks, under the direction of the Secretary of Commerce, and the Plant Variety Protection Office shall promulgate final regulations to implement the federal transfer statement established by this subsection not later than ____ days after the date

of enactment of this Act, and those regulations shall become effective not later than ____ days after the date of enactment of this Act.

(3) Federal marks shall be transferable to the secured party in accordance with applicable non-federal law and subsection (c)(2)(G) above even though such party does not engage in or intend to enter the business to which the Federal mark relates, provided that the secured party holds the Federal mark only for the purpose of subsequently transferring it along with the goodwill relating to the Federal mark, and that such subsequent transfer occurs [prior to the dissipation of the goodwill][within a period no longer than __ months from the initial transfer].

(4) Any person that files a federal financing statement, amendment, assignment statement, continuation statement, termination statement, release statement or transfer statement that the person is not entitled to file shall be liable for damages to the debtor or secured party in the amount of any loss proximately caused by such filing, which may include loss resulting from the debtor's inability to obtain, or increased costs of, alternative financing. In addition to any damages recoverable by a debtor under the preceding sentence, the debtor may recover from such person \$1,000. A prevailing party in any action under this paragraph may recover reasonable attorneys' fees from the non-prevailing parties.

(5) Whenever there is no outstanding secured obligation of a debtor to the secured party of record and the secured party is not subject to any commitment to make advances to the debtor, incur obligations or otherwise give value, if within ten days after written demand therefor by the debtor the secured party fails to either file a termination statement or send to the debtor such a termination statement, the secured party shall be liable to the debtor for \$1,000. A prevailing party in any action under this paragraph may recover reasonable attorneys' fees from the non-prevailing parties.

(6) Notwithstanding the provisions of 28 U.S.C. §1338, the federal district courts and the courts of the states shall have concurrent jurisdiction with respect to any civil action arising under paragraphs (4) or (5) above.

(d) Federal Intellectual Property Filing Center

The Secretary of Commerce in consultation with the Commissioner of Patents and Trademarks, the Register of Copyrights and the Plant Variety Protection Office shall establish the Federal Intellectual Property Filing Center. The Federal Intellectual Property Filing Center shall: (1) receive and manage the filings of federal financing statements as defined in § 3(a)(3) and provided for in § 3(c)(1)&(2), (2) create and manage the National Integrated Financing Statement Database provided for under the next section and, (3) serve as a repository for such other information about Federal Intellectual Property Rights as is necessary or useful in carrying out the statutory or treaty obligations of the United States.

(e) National Integrated Financing Statement Database

The Secretary of Commerce shall maintain an internet accessible information database within the Federal Intellectual Property Filing Center that contains or serves as an electronic repository for qualified state financing statements defined under § 3(a)(11) and properly designated and made available as such by state security interest filing offices under § 3(f). The Federal Intellectual Property Filing Center shall keep, by electronic means, a record of the date and hour when a qualified state financing statement was posted to the Database. Qualified state financing statements “posted” to the National Integrated Financing Statement Database within the meaning of § 3(a)(15) shall be electronically integrated by the Federal Intellectual Property Filing Center with federal financing statements filed directly with the Center. The database(s) maintained by the Federal Intellectual Property Filing Center shall be adequate to search and identify security interests by the name of the debtor. The Center shall develop an electronic system to efficiently integrate the debtor name information in such database(s) with the names of immediate ownership transferors and ownership transferees that appear in the applicable federal intellectual property records.

(f) Designation of Qualified State Financing Statements

(1) In order for a financing statement filed under state law to be properly designated as a “qualified state financing statement”: (1) the financing statement form used by the state must provide a means for the

secured party to mark or otherwise indicate that the statement covers all or any of the debtor's general intangibles and the original financing statement filed must be so indicated or marked, (2) the financing statement must be filed in electronic record form under the applicable non-federal law or transcribed in electronic record form under state filing office guidelines that call for such transcription to occur within no more than 5 business days after the state law filing date for such financing statement and, (3) the financing statement and all subsequent amendments continuations and assignments must be made available in electronic record form so as to enable their integration [by internet link or other electronic means] with similarly designated financing statements from other states within the National Integrated Financing Statement Database.

(2) Financing statements that are properly designated as qualified state financing statements under the preceding subsection, that otherwise satisfy the definition in § 3(a)(11), and that are posted in the National Integrated Financing Statement Database are the equivalent of a filed federal financing statement under the priority provisions in § 3(b).

(g) Financing Statement Certificates

Upon request and tender of the required fee, the Federal Intellectual Property Filing Center shall issue a certificate showing whether there is on file in the integrated database referred to in § 3(e) on the date and hour stated therein, any effective federal financing statement or qualified state financing statement naming a particular debtor and any assignment statement thereof and, if there is, giving the date and hour of filing or posting of each such statement, the collateral covered, and the name and address of each secured party therein.

(h) Availability of Record Information

(1) If the person filing any federal financing statement, amendment, assignment statement, continuation statement, termination statement, release statement or transfer statement furnishes the Federal Intellectual Property Filing Center a copy thereof, the Center shall upon request note upon the copy the file number and date and hour of the filing of the original and deliver or send the copy to such person. The Center may charge a fee for such record information as specified in subsection (i).

(2) If the person filing any qualified state financing statement, or any subsequent amendment, assignment statement, continuation statement, termination statement, release statement or transfer statement furnishes the Federal Intellectual Property Filing Center a copy thereof, the Center shall upon request note upon the copy the date and hour when the original was posted in the National Integrated Financing Statement Database and deliver or send the copy to such person. The Center may charge a fee for such record information as specified in subsection (i).

(3) Copies or reproductions of filed federal financing statements or qualified state financing statements that have been posted in the National Integrated Financing Statement Database and other filings related thereto shall be furnished by the end of the fifth business day after request and payment of the fees specified by subsection (i).

(i) Fees

The fees for filings and other recording services in the National Intellectual Property Filing Center under this Act shall be established by the Secretary of Commerce.

(j) Regulatory Authority

The Secretary of Commerce shall promulgate final regulations to implement the functions of the Federal Intellectual Property Filing Center and the National Integrated Financing Statement Database established under this Act not later than ____ days after the date of enactment of this Act, and those regulations shall become effective not later than ____ days after the date of enactment of this Act. The Federal Intellectual Property Filing Center is authorized to maintain a filing system utilizing electronic, voice, optical, and other information transmission, storage, processing, maintenance and retrieval technologies. The Federal Intellectual Property Filing Center shall also issue such other regulations as they determine to be appropriate to carry out the purposes of this Act, including regulations, if any, necessary and sufficient to permit submission and retrieval of information from the database(s) established pursuant to § 3(e).

**SECTION 4. CONFORMING AMENDMENTS TO STATUTES
DEALING WITH FEDERAL INTELLECTUAL PROPERTY RIGHTS**

(a) Copyright Act and Mask Works.

(1) Replace the existing definition of “transfer of copyright ownership” in 17 U.S.C. §101 with the following:

A “transfer of copyright ownership” is an assignment, exclusive license or any other conveyance or alienation of a copyright or of any of the exclusive rights comprised in a copyright, whether or not it is limited in time or place of effect, but not including a nonexclusive license or the grant of a security interest.

(2) Amend 17 U.S.C. §205(d) to read as follows:

- (d) *Priority between conflicting transfers.* - As between two conflicting transfers of copyright ownership, the one executed first prevails if it is recorded, in the manner required to give constructive notice under subsection (c), at any time before recordation in such manner of the later transfer. Otherwise the later transfer prevails if recorded first in such manner, and if taken in good faith, for value, and without notice of the earlier transfer. A lien creditor (whether real or provided for in hypothetical form under Title 11 of the United States Code) is not a transferee for value under the preceding sentence.

(3) Add a new 17 U.S.C. §205(f) to read as follows:

- (f) Notwithstanding subsections 205(a)-(e), the provisions of section 205 shall not apply to the creation, attachment, perfection, effect of perfection, priority or enforcement of a security interest in a copyright or the proceeds thereof; no document creating, evidencing or otherwise relating to the creation or perfection of a security interest shall be

required to be recorded under section 205; and the recordation of a document under section 205 shall not give constructive notice of any fact relating to the existence or priority of any security interest; provided, however, that transfer statements submitted in accordance with section 3(c)(2)(G) of the Intellectual Property Collateral Coordination Act shall be recorded and once recorded shall give constructive notice under subsection (a) of the contents thereof.

(4) Amend 17 U.S.C. §903(c) to read as follows:

(c) (1) Any document pertaining to a mask work may be recorded in the Copyright Office if the document filed for recordation bears the actual signature of the person who executed it, or if it is accompanied by a sworn or official certification that it is a true copy of the original, signed document. The Copyright Office shall, upon receipt of the document and the fee specified pursuant to subsection 908(d), record the document and return it with a certificate of recordation. The recordation of any transfer or license under this paragraph gives all persons constructive notice of the facts stated in the recorded document concerning the transfer or license.

(2) Notwithstanding subsections 903(a)-(d), the provisions of section 903 shall not apply to the creation, attachment, perfection, effect of perfection, priority or enforcement of a security interest in a mask work or the proceeds thereof; no document creating, evidencing or otherwise relating to the creation or perfection of a security interest shall be required to be recorded under section 903; and the recordation of a document under section 903 shall not give constructive notice of any fact relating to the existence or priority of any security interest; provided, however, that transfer statements submitted in accordance with subsection 3(c)(2)(G)

of the Intellectual Property Collateral Coordination Act shall be recorded and shall give constructive notice under subsection (a) of the contents thereof.

(b) Lanham Act

Replace 15 U.S.C. §1060 with the following:

§ 1060. Assignment of mark; execution; recording; purchaser without notice

A registered mark or a mark for which an application to register has been filed shall be assignable with the goodwill of the business connected with the use of and symbolized by the mark. However, no application to register a mark under section 1051(b) of this title shall be assignable prior to the filing of the amendment under section 1051(a) or the verified statement of use under section 1051(d) of this title, except to a successor to the business of the applicant, or portion thereof, to which the mark pertains, if that business is ongoing and existing. In any assignment authorized by this section or by section 3(c) of the Intellectual Property Collateral Coordination Act, it shall not be necessary to include the goodwill of the business connected with the use of and symbolized by any other mark used in the business or by the name or style under which the business is conducted.

Assignments shall be by instruments in writing duly executed. Acknowledgment shall be prima facie evidence of the execution of an assignment and when recorded in the Patent and Trademark Office the record shall be prima facie evidence of execution. An assignment (but not of a security interest in a registered trademark or a in an application to register) shall be void as against any subsequent purchaser for a valuable consideration without notice, unless it is recorded in the Patent and Trademark Office prior to such subsequent purchase. A separate record of assignments submitted for recording hereunder shall be maintained in the Patent and Trademark Office. An assignee not domiciled in the United States shall be subject to and comply with the

provisions of section 1051(e) of this title. Except as provided in sections 3(b) and 3(c) of the Intellectual Property Collateral Coordination Act, the rights and obligations of all persons with respect to a security interest in a registered trademark, an application to register, or the proceeds of either, including matters of creation, attachment, perfection, effect of perfection, priority, and enforcement, shall be governed by non-federal law relating to security interests in personal property.

(c) Patent Act

Amend the last paragraph of 35 U.S.C. §261 to read as follows:

An assignment, grant or conveyance of a patent application or a patent (but not of a security interest in a patent application or a patent) shall be void as against any subsequent purchaser for value, without notice, unless it is recorded in the Patent and Trademark Office within ten days from its date or prior to the date of such subsequent purchase. Except as provided in section 3(b) and 3(c) of the Intellectual Property Collateral Coordination Act, the rights and obligations of all persons with respect to a security interest in a patent, a patent application, or the proceeds of either, including matters of creation, attachment, perfection, effect of perfection, priority, and enforcement, shall be governed by non-federal law relating to security interests in personal property.

**(d)-(f) RESERVED FOR CONFORMING AMENDMENTS
TO THE PLANT VARIETY PROTECTION ACT, 7
U.S.C. §2321 et seq, THE VESSEL HULL DESIGN
PROTECTION ACT, 17 U.S.C. §501 et seq. AND
CHAPTER 180 OF TITLE 28, U.S. CODE
(ASSUMPTION OF CONTRACTUAL OBLIGATIONS
RELATED TO TRANSFERS OF RIGHTS IN MOTION
PICTURES)**

(g) Accommodation of New Filing Technologies

All references in this Act and in the Lanham Act, the Patent Act and the Copyright Act to filings relating to security interests shall not be limited to paper documents but shall include electronic, voice, optical, and such other information transmission, storage, processing, maintenance, and retrieval technologies as shall be approved for such purposes by the Federal Intellectual Property Filing Center, the Register of Copyrights, the Commissioner of Patents and Trademarks and the Plant Variety Protection Office from time to time.

SECTION 5. REPORT TO CONGRESS

The Secretary of Commerce shall report to the _____ Committee of the _____ not later than _____ days after the enactment of this Act regarding their plans to comply with the requirements of this Act.

SECTION 6. EFFECTIVE DATES

(a) This Act shall become effective on the date of enactment, except that the provisions of section 3(c)(2)(G) shall not become effective until the effective date of the regulations described therein and the provisions of sections 3(b)(2)(B), 3(c)(1), 3(c)(2)(A)-(F), 3(d)-(i) shall not become effective until the effective date of the regulations described in subsection 3(j)

(b) Section 3(b)(2)(A), (C) & (D) shall apply to all security interests in effect under applicable non-federal law on the date of enactment.

**APPENDIX 2 - INTELLECTUAL PROPERTY SECURITY INTEREST
COORDINATION ACT**

**INTELLECTUAL PROPERTY SECURITY INTEREST
COORDINATION ACT**

106th Congress; 1st Session

In the [House of Representatives/Senate]

[H.R/S.] No. _____

SYNOPSIS:

AN ACT to facilitate the efficient use of federal intellectual property as collateral by linking the current federal tract recording systems covering federal intellectual property title with the existing and developing state filing systems for perfecting security interests in all forms of intangible personal property and to create for that purpose a central notice filing database for state security interest filings that cover federal intellectual property.

DATE OF INTRODUCTION: _____, 2001

SPONSORS: [_____]

TEXT:

Be it enacted by the Senate and House of Representatives of
the United States of America in Congress assembled:

SECTION 1. SHORT TITLE.

This Act may be cited as the “Intellectual Property Security Interest
Coordination Act.”

SECTION 2. FINDINGS AND PURPOSES.**(a) Findings**

Congress finds the following:

(1) Enterprises of all size must be able to finance their business activities by obtaining secured credit. Secured financing is often critical to the research and development that leads to the creation of intellectual property. The more secure and predictable the lender's rights and security are, the better terms the borrower can obtain. Conversely, the risk of loss, subordination, impairment or other uncertainties with respect to collateral inhibit the financing desired by all parties. Predictability and uniformity of treatment with respect to intellectual property collateral further the interests of all parties involved in related commercial transactions whether those parties are intellectual property owners, licensees, or their lenders.

(2) In many cases, a company's intellectual property is among the assets most valuable and useful as collateral in obtaining desired financing. Increasingly, companies' assets and entrepreneurial energies are focused on a combination of various forms of intellectual property, and the same product or process may involve a combination of patents, copyrights, trademarks, trade secrets and other intellectual property. Moreover, these intellectual property assets may be protected under the laws of other nations and prospective financiers of these assets may be located outside the United States.

(3) The law governing security interests in all forms of personal property (including intangible forms) has historically been state law. Article 9 of the Uniform Commercial Code, as recently revised, provides a uniform structure for this law between and among the various states. However, the most important forms of intangible intellectual property are either created or enhanced by federal statutory provisions that provide their own recording systems for tracking title and ownership rights in this property. Courts have struggled with the question of whether and to what extent these somewhat dated federal recording statutes should displace the generally well-conceived state law structure (Article 9) when the rights of secured parties in federal intellectual property are at stake. The federal tract recording statutes embrace security interests only as a form or variant of title to specific items of property recorded under specific property numbers.

Furthermore these federal recording provisions vary depending on whether the intellectual property is patents, copyrights or trademarks.

(4) Some federal lower court decisions have held that the only way to perfect a security interest in a copyright, in material that is copyrightable, or in proceeds of such material is to file the equivalent of a copyright mortgage with the U.S. Copyright Office. These decisions include *In re Peregrine Entertainment Ltd.*, 116 B.R. 194 (C.D. Cal.1990); *In re AEG Acquisition Corp.*, 127 B.R. 34 (Bankr. C.D. Cal. 1991), *amended* 161 B.R. 50 (9th Cir. BAP 1993); and *In re Avalon Software, Inc.*, 209 B.R. 517 (Bankr. D. Ariz. 1997). In something of a retreat from this position, one recent bankruptcy court decision has concluded that federal recording of a security interest in a copyright is necessary only where the copyright is registered. *In re World Auxiliary Power Co.*, 244 B.R. 149 (Bankr. N.D. Calif. 1999).

The cases involving patent collateral have generally upheld secured party lien perfection through state notice filings (Article 9) against the bankruptcy trustee - but have uniformly suggested that the same financing secured party must make a federal assignment filing with the USPTO to be protected against later assignees or mortgagees who take and record patent title instruments. See *In re Cybernetic Services, Inc.*, 239 B.R. 917, 920 at n.8 (9th Cir. B.A.P. 1999). See also *City Bank and Trust Co. v. Otto Fabric, Inc.*, 83 B.R. 780, 782 (D. Kan. 1988), *relying on*, *In re Transportation Design and Technology, Inc.*, 48 B.R. 635, 639, 40 UCC 1393, 1398 (Bankr. S.D. Cal. 1985).

The cases involve trademark collateral have found state law (Article 9) filing sufficient notice. However, this state law notice has not been tested in the cases against an assignee of a mark who relies exclusively on the federal assignment record. See *Roman Cleanser v. National Acceptance Co.*, 43 B.R. 940, 945 (Bankr. E.D. Mich. 1984), *aff'd*, 802 F.2d 207 (6th Cir. 1986); *In re 199Z, Inc.*, 137 B.R. 778, 781-82 (Bankr. C.D. Cal. 1992). See also *In re C.C. & Co.*, 85 B.R. 485, 487 (Bankr. E.D. Va. 1988) ("A grant of a security interest is merely a device to secure indebtedness.")

(5) Because they are tract type systems that rely on specific assigned property numbers, the federal systems for registering interests in intellectual property, unlike the Article 9-based state filing systems, do not provide for notice filing under the debtor's name, for generic descriptions of collateral, or for perfection of security interests in

subsequently-acquired property. As a result of the structural rigidity of the current federal recording provisions, companies seeking financing and their lenders have either had to incur the time and expense of additional and frequent recordings and registrations that would not otherwise have been made, or forego financing opportunities.

(6) This Act makes substantive and procedural changes to the law in order to integrate notice filings covering security interests from the various states and the federal intellectual property records in order to facilitate the efficient financing of federal intellectual property, consistent with the rights of owners and assignees of interests in such property.

(b) Purposes

Based upon the powers contained in Article I, Section 8, Clause 3; Article I, Section 8, Clause 8 and other provisions of the Constitution of the United States, the purposes of this Act are:

(1) To promote financing and development of federal intellectual property assets by clarifying the methods for perfecting security interests in such collateral, and by making all forms of intellectual property collateral as accessible, valuable and useful as possible;

(2) To assist businesses (and, through them, consumers and others) in obtaining credit on the best available terms; and

(3) To lessen the burdens on interstate commerce and commerce between the United States and other nations by reducing legal risks associated with the inconsistent treatment of different types of federal intellectual property.

(4) To provide an accessible integrated national filing system built around an integrated database for all security interests that cover this important federal statutory property and to enable future international access to and integration with this system and database.

**SECTION 3. SECURITY INTERESTS IN INTELLECTUAL
PROPERTY SUBJECT TO FEDERAL LAW**

(a) Definitions

The following definitions shall apply for purposes of this Act:

- (1) The term “copyright” means any of the exclusive rights comprised in a copyright under chapter 1 of title 17, United States Code, whether or not registered under chapter 4 of such title.
- (2) The “Federal Intellectual Property Data Center” refers to the office formed within the Department of Commerce under § 3(d) of this Act that is charged with the creation and maintenance of the file and associated records connected with qualified state financing statements posted within the National Integrated Financing Statement Database.
- (3) The term “Federal Intellectual Property Rights” means copyrights, patents, Federal marks, mask works, plant variety protection rights and vessel hull design protection rights.
- (4) The term “Federal mark” means a mark that is registered pursuant to the Lanham Act (15 U.S.C. §1051 et seq.), or for which an application for such registration is pending with the U.S. Patent and Trademark Office.
- (5) An “immediate ownership transferor” means a person who transfers directly to an ownership transferee any right or interest (other than a security interest) in, or ownership of, a Federal Intellectual Property Right.
- (6) The term “mark” has the meaning given in section 45 of the Lanham Act (15 U.S.C. §1127).
- (7) The term “mask work” has the meaning given in section 901 of title 17, United States Code.
- (8) An “ownership transferee” means a person other than a secured party or lien creditor who acquires any right or interest (other than a security interest) in, or ownership of, a Federal Intellectual Property Right.

- (9) A “qualified state financing statement” means a financing statement that: (1) is filed under applicable non-federal law governing security interests in personal property and in compliance with the requirements for filing in the state where filing occurs, (2) contains a description of collateral that would be sufficient to cover the debtor’s Federal Intellectual Property Rights under applicable non-federal law and, (3) is designated as such and made electronically available by the filing state to the National Integrated Financing Statement Database as provided in § 3(f). Unless the context otherwise requires, the term “qualified state financing statement” includes the original federal financing statement and any filed amendments, continuations and assignments.
- (10) The term “patent” means a patent or a pending application for a patent under title 35, United States Code.
- (11) The term "plant variety protection rights" means a certificate of plant variety protection or a pending application for such a certificate under chapter 57 of title 7, United States Code.
- (12) The term “person” means an individual, corporation, partnership, limited liability company, business trust, estate, trust, association, joint venture, government or governmental subdivision or agency, or any other legal or commercial entity.
- (13) The term “posting” with respect to a qualified state financing statement refers to the time when such statement is made accessible [by internet link or other electronic means] within the National Integrated Financing Statement Database provided for in § 3(e).
- (14) The term “state” refers to the states of the United States and to all possessions and territories of the United States.
- (15) The term "vessel hull design protection rights" means a certificate of registration or a pending application for such a certificate under chapter 13 of title 17, United States Code.

- (16) Unless otherwise provided by this Act, the terms "authenticate", "collateral", "debtor", "financing statement", "good faith", "general intangible", "lien creditor", knowledge, "notice", "proceeds", "representative" "secured party", "security agreement", "security interest", "signed" or "signature" and "value" shall have the meanings given to such terms under applicable non-federal law relating to security interests in personal property.

(b) Security Interests

(1) This section applies to all security interests in Federal Intellectual Property Rights and in the proceeds thereof which interests are created by contract, regardless of form and nomenclature.

(2) (A) The creation, attachment, perfection, effect of perfection, priority and enforcement of a security interest in a Federal Intellectual Property Right or in the proceeds thereof relative to all competing rights, claims, and interests therein and licenses thereof shall be determined by applicable non-federal law governing security interests in personal property, except as provided in subsections (b)(2)(B) and (b)(2)(C). The creation, attachment, perfection, effect of perfection, priority and enforcement of any right or interest (other than a security interest) in, or ownership of, a Federal Intellectual Property Right shall be determined by the applicable federal law governing such Federal Intellectual Property Right.

(B) A security interest in a Federal Intellectual Property Right is subordinate to the rights of an ownership transferee who gives value without knowledge of the security interest, if (i) the document transferring the Federal Intellectual Property Right to the ownership transferee is executed before the posting of a qualified state financing statement that names as a debtor a person that is or was an immediate ownership transferor of such Federal Intellectual Property Right and, (ii) such ownership transferee makes an effective recordation of the transfer document in the manner required under applicable federal law (as amended by Section 4 of this Act) to give priority to such transferee - (a) within 10 days of the execution date of the document of transfer or - (b) before the posting of such qualified state financing statement. [The rule in this subsection does not displace otherwise applicable non-federal law until the effective date provided in § 6(a).]

(C) A security interest in any Federal Intellectual Property Right created by a specific debtor is subordinate to the rights of an ownership transferee of such Right who takes from the same immediate ownership transferor as the debtor whenever such ownership transferee has priority over that specific debtor under the applicable federal law on recording and priority that governs such Federal Intellectual Property Right.

(D) A security interest in a Federal Intellectual Property Right that has not been made subordinate under either of the two preceding subsections has priority over such ownership transferee of such Right if and to the extent that such security interest meets the requirements for priority as provided under applicable non-federal law governing security interests in personal property.

(c) Federal Transfer Statements

(1) With respect to any Federal Intellectual Property Rights that are subject to a security interest (whether or not perfected) as to which the secured party has exercised its post-default rights or remedies, the person that is the transferee of such Federal Intellectual Property Rights as a result of such exercise of rights or remedies may file in the appropriate Federal record a transfer statement that:

- (i) states the name of the debtor and the name and mailing address of the secured party;
- (ii) identifies the Federal Intellectual Property Rights transferred;
- (iii) identifies, by file number the qualified state financing statement previously filed by the secured party covering Federal Intellectual Property Rights that is posted in the National Integrated Financing Statement Database.
- (iv) states the name and mailing address of the transferee of the Federal Intellectual Property Rights (which may but need not be the secured party); and

(v) states that: (a) the secured party had a security interest in the Federal Intellectual Property Rights (and, in the case of Federal marks, in the goodwill of the business connected with the use of and symbolized by such Federal marks); (b) the debtor defaulted in connection with an obligation secured by the Federal Intellectual Property Rights and such default has not been cured; (c) the debtor has been given at least 5 days prior written notice of the transfer (which notice shall be deemed given if the secured party shall have complied with the notice requirements of applicable non-federal law in connection with the foreclosure upon, or other disposition of, collateral other than such Federal Intellectual Property Rights); and (d) the identified transferee of the Federal Intellectual Property Rights has complied with all requirements imposed by federal law as a condition to the effectiveness of a transfer of such Federal Intellectual Property Right and is entitled to the transfer of record of the interest of the debtor in the Federal Intellectual Property Rights transferred by reason of the secured party's exercise of its post-default rights or remedies in accordance with applicable non-federal law. A transfer statement that identifies an intent to use application under 15 U.S.C. § 1051(b) among the Federal Intellectual Property Rights transferred may not be filed or recorded under this section unless the transferee is a successor to the business of the applicant debtor within the meaning of 15 U.S.C. § 1060(a). A transfer statement filed or recorded in violation of such prohibition shall have no force or effect on any of the Federal Intellectual Property Rights identified therein.

Recordation by a transferee of such a transfer statement in the appropriate federal record and in the manner required under applicable federal law (as amended by Section 4 of this Act) to give priority to such transferee's interest in the Federal Intellectual Property Right shall, if the transferee has complied with all other requirements imposed by federal law as a condition to the effectiveness of a transfer of such Federal Intellectual Property Right, serve as an effective document of transfer to the identified transferee, of the interest of the debtor and the secured party in the Federal Intellectual Property Rights transferred. Such recordation of the transfer statement shall also be effective for all public record purposes under the appropriate federal recording requirement.

(2) Federal marks shall be transferable to the secured party in accordance with applicable non-federal law and under the preceding subsection even though such party does not engage in or intend to enter the business to which the Federal mark relates, provided that the secured party holds the Federal mark only for the purpose of subsequently transferring it along with the goodwill relating to the Federal mark, and that such subsequent transfer occurs [prior to the dissipation of the goodwill][within a period no longer than ___ months from the initial transfer.]

(3) The Register of Copyrights, subject to the approval of the Librarian of Congress, the Commissioner of Patents and Trademarks, under the direction of the Secretary of Commerce, and the Plant Variety Protection Office shall promulgate final regulations to implement the federal transfer statement established by this subsection not later than ___ days after the date of enactment of this Act, and those regulations shall become effective not later than ___ days after the date of enactment of this Act.

(d) Federal Intellectual Property Data Center

The Secretary of Commerce in consultation with the Commissioner of Patents and Trademarks, the Register of Copyrights and the Plant Variety Protection Office shall establish the Federal Intellectual Property Data Center. The Federal Intellectual Property Data Center shall: (1) create and manage the National Integrated Financing Statement Database provided for under the next section and, (2) serve as a repository for such other information about Federal Intellectual Property Rights as is necessary or useful in carrying out the statutory or treaty obligations of the United States.

(e) National Integrated Financing Statement Database

The Secretary of Commerce shall maintain an Internet accessible information database within the Federal Intellectual Property Data Center that contains or serves as an electronic repository for qualified state financing statements defined under § 3(a)(11) and properly designated and made available as such by state security interest filing offices under § 3(f). The Federal Intellectual Property Data Center shall keep, by electronic means, a record of the date and hour when a qualified state financing statement was posted to the Database. Qualified state financing statements “posted” to the National Integrated Financing Statement Database within the meaning of §

3(a)(15) shall be electronically integrated by the Federal Intellectual Property Data Center with all other similar statements. The database(s) maintained by the Federal Intellectual Property Data Center shall be adequate to search and identify security interests by the name of the debtor. The Center shall develop an electronic system to efficiently integrate the debtor name information in such database(s) with the names of immediate ownership transferors and ownership transferees that appear in the applicable federal intellectual property records.

(f) Designation of Qualified State Financing Statements

(1) In order for a financing statement filed under state law to be properly designated as a “qualified state financing statement”: (1) the financing statement form used by the state must provide a means for the secured party to mark or otherwise indicate that the statement covers all or any of the debtor’s general intangibles and the original financing statement filed must be so indicated or marked, (2) the financing statement must be filed in electronic record form under the applicable non-federal law or transcribed in electronic record form under state filing office guidelines that call for such transcription to occur within no more than 5 business days after the state law filing date for such financing statement and, (3) the financing statement and all subsequent amendments continuations and assignments must be made available in electronic record form so as to enable their integration [by internet link or other electronic means] with similarly designated financing statements from other states within the National Integrated Financing Statement Database.

(2) Financing statements that are properly designated as qualified state financing statements under the preceding subsection, that otherwise satisfy the definition in § 3(a)(11), and that are posted in the National Integrated Financing Statement Database provide notice of the underlying security interest within the meaning of § 3(b).

(g) Financing Statement Certificates

Upon request and tender of the required fee, the Federal Intellectual Property Data Center shall issue a certificate showing whether there is on file in the integrated database referred to in § 3(e) on the date and hour stated therein, any qualified state financing statement naming a particular debtor

and any assignment statement thereof and, if there is, giving the date and hour of the posting of each such statement, the collateral covered, and the name and address of each secured party therein.

(h) Availability of Record Information

(1) If the person filing any qualified state financing statement, or any subsequent amendment, assignment statement, continuation statement, termination statement, release statement or transfer statement furnishes the Federal Intellectual Property Data Center a copy thereof, the Center shall upon request note upon the copy the date and hour when the original was posted in the National Integrated Financing Statement Database and deliver or send the copy to such person. The Center may charge a fee for such record information as specified in subsection (i).

(2) Copies or reproductions of qualified state financing statements that have been posted in the National Integrated Financing Statement Database and other filings related thereto shall be furnished by the end of the fifth business day after request and payment of the fees specified by subsection (i).

(i) Fees

The fees for filings and other recording services in the National Intellectual Property Filing Center under this Act shall be established by the Secretary of Commerce.

(j) Regulatory Authority

The Secretary of Commerce shall promulgate final regulations to implement the functions of the Federal Intellectual Property Data Center and the National Integrated Financing Statement Database established under this Act not later than ____ days after the date of enactment of this Act, and those regulations shall become effective not later than ____ days after the date of enactment of this Act. The Federal Intellectual Property Data Center is authorized to maintain databases utilizing electronic, voice, optical, and other information transmission, storage, processing, maintenance and retrieval technologies. The Federal Intellectual Property Data Center shall also issue such other regulations as they determine to be appropriate to carry out the purposes of this Act, including regulations, if any, necessary and sufficient to permit submission and retrieval of information from the database(s) established pursuant to § 3(e).

**SECTION 4. CONFORMING AMENDMENTS TO STATUTES
DEALING WITH FEDERAL INTELLECTUAL PROPERTY RIGHTS**

(a) Copyright Act and Mask Works.

(1) Replace the existing definition of “transfer of copyright ownership” in 17 U.S.C. §101 with the following:

A “transfer of copyright ownership” is an assignment, exclusive license or any other conveyance or alienation of a copyright or of any of the exclusive rights comprised in a copyright, whether or not it is limited in time or place of effect, but not including a nonexclusive license or the grant of a security interest.

(2) Amend 17 U.S.C. §205(d) to read as follows:

(d) *Priority between conflicting transfers* - As between two conflicting transfers of copyright ownership, the one executed first prevails if it is recorded, in the manner required to give constructive notice under subsection (c), at any time before recordation in such manner of the later transfer. Otherwise the later transfer prevails if recorded first in such manner, and if taken in good faith, for value, and without notice of the earlier transfer. A lien creditor (whether real or provided for in hypothetical form under Title 11 of the United States Code) is not a transferee for value under the preceding sentence.

(3) Add a new 17 U.S.C. §205(f) to read as follows:

(f) Notwithstanding subsections 205(a)-(e), the provisions of section 205 shall not apply to the creation, attachment, perfection, effect of perfection, priority or enforcement of a security interest in a copyright or the proceeds thereof; no document creating, evidencing or otherwise relating to the creation or perfection of a security interest shall be required to be recorded under section 205; and the recordation of a document under section 205 shall not give constructive notice of any fact relating to

the existence or priority of any security interest; provided, however, that transfer statements submitted in accordance with section 3(c)(2)(G) of the Intellectual Property Security Interest Coordination Act shall be recorded and once recorded shall give constructive notice under subsection (a) of the contents thereof.

(4) Amend 17 U.S.C. §903(c) to read as follows:

(c) (1) Any document pertaining to a mask work may be recorded in the Copyright Office if the document filed for recordation bears the actual signature of the person who executed it, or if it is accompanied by a sworn or official certification that it is a true copy of the original, signed document. The Copyright Office shall, upon receipt of the document and the fee specified pursuant to subsection 908(d), record the document and return it with a certificate of recordation. The recordation of any transfer or license under this paragraph gives all persons constructive notice of the facts stated in the recorded document concerning the transfer or license.

(2) Notwithstanding subsections 903(a)-(d), the provisions of section 903 shall not apply to the creation, attachment, perfection, effect of perfection, priority or enforcement of a security interest in a mask work or the proceeds thereof; no document creating, evidencing or otherwise relating to the creation or perfection of a security interest shall be required to be recorded under section 903; and the recordation of a document under section 903 shall not give constructive notice of any fact relating to the existence or priority of any security interest; provided, however, that transfer statements submitted in accordance with subsection 3(c)(2)(G) of the Intellectual Property Security Interest Coordination Act shall be recorded and shall give

constructive notice under subsection (a) of the contents thereof.

(b) Lanham Act

Replace 15 U.S.C. §1060 with the following:

§ 1060. Assignment of mark; execution; recording; purchaser without notice

A registered mark or a mark for which an application to register has been filed shall be assignable with the goodwill of the business connected with the use of and symbolized by the mark. However, no application to register a mark under section 1051(b) of this title shall be assignable prior to the filing of the amendment under section 1051(a) or the verified statement of use under section 1051(d) of this title, except to a successor to the business of the applicant, or portion thereof, to which the mark pertains, if that business is ongoing and existing. In any assignment authorized by this section or by section 3(c) of the Intellectual Property Security Interest Coordination Act, it shall not be necessary to include the goodwill of the business connected with the use of and symbolized by any other mark used in the business or by the name or style under which the business is conducted. Assignments shall be by instruments in writing duly executed. Acknowledgment shall be prima facie evidence of the execution of an assignment and when recorded in the Patent and Trademark Office the record shall be prima facie evidence of execution. An assignment (but not of a security interest in a registered trademark or an application to register) shall be void as against any subsequent purchaser for a valuable consideration without notice, unless it is recorded in the Patent and Trademark Office prior to such subsequent purchase. A separate record of assignments submitted for recording hereunder shall be maintained in the Patent and Trademark Office. An assignee not domiciled in the United States shall be subject to and comply with the provisions of section 1051(e) of this title. Except as provided in sections 3(b) and 3(c) of the Intellectual Property Security Interest Coordination Act, the

rights and obligations of all persons with respect to a security interest in a registered trademark, an application to register, or the proceeds of either, including matters of creation, attachment, perfection, effect of perfection, priority, and enforcement, shall be governed by non-federal law relating to security interests in personal property.

(c) Patent Act

Amend the last paragraph of 35 U.S.C. §261 to read as follows:

An assignment, grant or conveyance of a patent application or a patent (but not of a security interest in a patent application or a patent) shall be void as against any subsequent purchaser for value, without notice, unless it is recorded in the Patent and Trademark Office within ten days from its date or prior to the date of such subsequent purchase. Except as provided in section 3(b) and 3(c) of the Intellectual Property Security Interest Coordination Act, the rights and obligations of all persons with respect to a security interest in a patent, a patent application, or the proceeds of either, including matters of creation, attachment, perfection, effect of perfection, priority, and enforcement, shall be governed by non-federal law relating to security interests in personal property.

(d)-(f) RESERVED FOR CONFORMING AMENDMENTS TO THE PLANT VARIETY PROTECTION ACT, 7 U.S.C. §2321 et seq, THE VESSEL HULL DESIGN PROTECTION ACT, 17 U.S.C. §501 et seq. AND CHAPTER 180 OF TITLE 28, U.S. CODE (ASSUMPTION OF CONTRACTUAL OBLIGATIONS RELATED TO TRANSFERS OF RIGHTS IN MOTION PICTURES)

(g) Accommodation of New Filing Technologies

All references in this Act and in the Lanham Act, the Patent Act and the Copyright Act to filings relating to security interests shall not be limited to paper documents but shall include electronic, voice, optical, and such other information transmission, storage, processing, maintenance, and retrieval technologies as shall be approved for such purposes by the Federal Intellectual Property Data Center, the Register of Copyrights, the Commissioner of Patents and Trademarks and the Plant Variety Protection Office from time to time.

SECTION 5. REPORT TO CONGRESS

The Secretary of Commerce shall report to the _____ Committee of the _____ not later than _____ days after the enactment of this Act regarding their plans to comply with the requirements of this Act.

SECTION 6. EFFECTIVE DATES

(a) This Act shall become effective on the date of enactment, except that the provisions of section 3(c) shall not become effective until the effective date of the regulations described in subsection 3(c)(3) and the provisions of sections 3(b)(2)(B) and 3(d) – 3(i) shall not become effective until the effective date of the regulations described in subsection 3(j).

(b) Section 3(b)(2)(A), (C) & (D) shall apply to all security interests in effect under applicable non-federal law on the date of enactment.

**APPENDIX 3 - SECURITY INTEREST IN INTELLECTUAL PROPERTY
RESTORATION ACT**

**SECURITY INTERESTS IN INTELLECTUAL PROPERTY
RESTORATION ACT**

106th Congress; 1st Session

In the [House of Representatives/Senate]

[H.R/S.] No. _____

SYNOPSIS:

AN ACT to facilitate the efficient use of federal intellectual property as collateral by providing for a Federal Intellectual Property Data Center that will gather lien information from various state filing offices and make that information accessible to transferees of federal intellectual property and to confirm that the traditional, practical and appropriate state law on security interest in personal property is not preempted by the tract recording provisions of existing federal intellectual property statutes.

DATE OF INTRODUCTION: _____, 2001

SPONSORS: [_____]

TEXT:

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled:

SECTION 1. SHORT TITLE.

This Act may be cited as the “Security Interests in Intellectual Property Restoration Act.”

SECTION 2. FINDINGS AND PURPOSES.**(a) Findings**

Congress finds the following:

(1) Enterprises of all size must be able to finance their business activities by obtaining secured credit. Secured financing is often critical to the research and development that leads to the creation of intellectual property. The more secure and predictable the lender's rights and security are, the better terms the borrower can obtain. Conversely, the risk of loss, subordination, impairment or other uncertainties with respect to collateral inhibit the financing desired by all parties. Predictability and uniformity of treatment with respect to intellectual property collateral further the interests of all parties involved in related commercial transactions whether those parties are intellectual property owners, licensees, or their lenders.

(2) In many cases, a company's intellectual property is among the assets most valuable and useful as collateral in obtaining desired financing. Increasingly, companies' assets and entrepreneurial energies are focused on a combination of various forms of intellectual property, and the same product or process may involve a combination of patents, copyrights, trademarks, trade secrets and other intellectual property. Moreover, these intellectual property assets may be protected under the laws of other nations and prospective financiers of these assets may be located outside the United States.

(3) The law governing security interests in all forms of personal property (including intangible forms) has historically been state law. Article 9 of the Uniform Commercial Code, as recently revised, provides a uniform structure for this law between and among the various states. Despite this well conceived uniform state law structure for security interests generally, the most important forms of intangible intellectual property are either created or enhanced by federal statutory provisions that provide their own recording systems for tracking title and ownership rights in this property. Courts have struggled with the question of whether and to what extent these somewhat dated federal recording statutes should displace the generally well-conceived state law structure (Article 9) when the rights of secured parties in federal intellectual property are at stake. The federal tract recording statutes embrace security interests only as a form or variant of title to specific items of property recorded under specific property numbers.

Furthermore these federal recording provisions vary depending on whether the intellectual property is patents, copyrights or trademarks.

(4) Some federal lower court decisions have held that the only way to perfect a security interest in a copyright, in material that is copyrightable, or in proceeds of such material is to file the equivalent of a copyright mortgage with the U.S. Copyright Office. These decisions include *In re Peregrine Entertainment Ltd.*, 116 B.R. 194 (C.D. Cal.1990); *In re AEG Acquisition Corp.*, 127 B.R. 34 (Bankr. C.D. Cal. 1991), *amended* 161 B.R. 50 (9th Cir. BAP 1993); and *In re Avalon Software, Inc.*, 209 B.R. 517 (Bankr. D. Ariz. 1997). In something of a retreat from this position, one recent bankruptcy court decision has concluded that federal recording of a security interest in a copyright is necessary only where the copyright is registered. *In re World Auxiliary Power Co.*, 244 B.R. 149 (Bankr. N.D. Calif. 1999).

The cases involving patent collateral have generally upheld secured party lien perfection through state notice filings (Article 9) against the bankruptcy trustee - but have uniformly suggested that the same financing secured party must make a federal assignment filing with the USPTO to be protected against later assignees or mortgagees who take and record patent title instruments. See *In re Cybernetic Services, Inc.*, 239 B.R. 917, 920 at n.8 (9th Cir. B.A.P. 1999). See also *City Bank and Trust Co. v. Otto Fabric, Inc.*, 83 B.R. 780, 782 (D. Kan. 1988), *relying on*, *In re Transportation Design and Technology, Inc.*, 48 B.R. 635, 639, 40 UCC 1393, 1398 (Bankr. S.D. Cal. 1985).

The cases involve trademark collateral have found state law (Article 9) filing sufficient notice. However, this state law notice has not been tested in the cases against an assignee of a mark who relies exclusively on the federal assignment record. See *Roman Cleanser v. National Acceptance Co.*, 43 B.R. 940, 945 (Bankr. E.D. Mich. 1984), *aff'd*, 802 F.2d 207 (6th Cir. 1986); *In re 199Z, Inc.*, 137 B.R. 778, 781-82 (Bankr. C.D. Cal. 1992). See also *In re C.C. & Co.*, 85 B.R. 485, 487 (Bankr. E.D. Va. 1988) ("A grant of a security interest is merely a device to secure indebtedness.")

(5) Because they are tract type systems that rely on specific assigned property numbers, the federal systems for registering interests in intellectual property, unlike the Article 9-based state filing systems, do not provide for notice filing under the debtor's name, for generic descriptions of collateral, or for perfection of security interests in subsequently-acquired property. As a result of the structural rigidity of the current federal recording provisions, companies seeking financing and their lenders have either had to incur the time and expense of additional and frequent recordings and registrations that would not otherwise have been made, or forego financing opportunities.

(6) This Act makes substantive and procedural changes to the law in order reverse lower court decisions holding that the federal tract records for federal intellectual property preempt, in whole or in part, the uniform state law on security interests when federal intellectual property is used as collateral. The Act also establishes a means for the eventual integration of the federal intellectual property records with state law notice filings covering security interests in federal intellectual property in order to make record searches on this property more efficient and consistent with the rights of owners and assignees of interests in such property.

(b) Purposes

Based upon the powers contained in Article I, Section 8, Clause 3; Article I, Section 8, Clause 8 and other provisions of the Constitution of the United States, the purposes of this Act are:

(1) To promote financing and development of federal intellectual property assets by clarifying the methods for perfecting security interests in such collateral, and by making all forms of intellectual property collateral as accessible, valuable and useful as possible;

(2) To assist businesses (and, through them, consumers and others) in obtaining credit on the best available terms; and

(3) To lessen the burdens on interstate commerce and commerce between the United States and other nations by reducing legal risks associated with the inconsistent treatment of different types of federal intellectual property.

(4) To provide a Federal Intellectual Property Data Center for the purpose of gathering electronically accessible security interest

information from the various states to enable the integration of this information with both federal and international records or databases.

**SECTION 3. SECURITY INTERESTS IN INTELLECTUAL
PROPERTY SUBJECT TO FEDERAL LAW.**

(a) Definitions

The following definitions shall apply for purposes of this Act:

- (1) The term “copyright” means any of the exclusive rights comprised in a copyright under chapter 1 of title 17, United States Code, whether or not registered under chapter 4 of such title.
- (2) The “Federal Intellectual Property Data Center” refers to the office formed within the Department of Commerce under § 3(d) of this Act that is charged with the integration and maintenance of the National Integrated Financing Statement Database and associated records connected with state filed financing statements.
- (3) The term “Federal Intellectual Property Rights” means copyrights, patents, Federal marks, mask works, plant variety protection rights and vessel hull design protection rights.
- (4) The term “Federal mark” means a mark that is registered pursuant to the Lanham Act (15 U.S.C. §1051 et seq.), or for which an application for such registration is pending with the U.S. Patent and Trademark Office.
- (5) An “immediate ownership transferor” means a person who transfers directly to an ownership transferee any right or interest (other than a security interest) in, or ownership of, a Federal Intellectual Property Right.
- (6) The term “mark” has the meaning given in section 45 of the Lanham Act (15 U.S.C. §1127).
- (7) The term “mask work” has the meaning given in section 901 of title 17, United States Code.

- (8) An “ownership transferee” means a person other than a secured party or lien creditor who acquires any right or interest in a Federal Intellectual Property Right that must be recorded under Federal Intellectual Property Recording statutes in order to be protected against subsequent transferees of such Right.
- (9) The term “patent” means a patent or a pending application for a patent under title 35, United States Code.
- (10) The term "plant variety protection rights" means a certificate of plant variety protection or a pending application for such a certificate under chapter 57 of title 7, United States Code.
- (11) The term “person” means an individual, corporation, partnership, limited liability company, business trust, estate, trust, association, joint venture, government or governmental subdivision or agency, or any other legal or commercial entity.
- (12) The term “state” refers to the states of the United States and to all possessions and territories of the United States.
- (13) The term "vessel hull design protection rights" means a certificate of registration or a pending application for such a certificate under chapter 13 of title 17, United States Code.
- (14) Unless otherwise provided by this Act, the terms "authenticate", "collateral", “debtor”, “financing statement”, “good faith”, “general intangible”, “lien creditor”, knowledge”, “notice”, “proceeds”, "representative" “secured party”, “security agreement”, “security interest”, “signed” or “signature” and “value” shall have the meanings given to such terms under applicable non-federal law relating to security interests in personal property.
- (15) An “immediate ownership transferor” means a person who transfers directly to an ownership transferee any right or interest (other than a security interest) in, or ownership of, a Federal Intellectual Property Right.

(b) Preservation of Uniform State Law on Security Interests in Federal Intellectual Property Rights

(1) This section applies to all security interests in Federal Intellectual Property Rights and in the proceeds thereof which interests are created by contract, regardless of form and nomenclature.

(2) (A) The creation, attachment, perfection, priority and enforcement of a security interest in a Federal Intellectual Property Right or in the proceeds thereof relative to all competing rights, claims, and interests therein and licenses thereof shall be determined by applicable non-federal law governing security interests in personal property, except as provided in subsections (b)(2)(B). The creation, transfer, validity, enforceability, perfection, priority and enforcement of any right or interest (other than a security interest) in, or ownership of, a Federal Intellectual Property Right shall be determined by the applicable federal law governing such Federal Intellectual Property Right.

(B) A security interest in any Federal Intellectual Property Right created by a specific debtor is subordinate to the rights of an ownership transferee of such Right who takes from the same immediate ownership transferor as the debtor whenever such ownership transferee has priority over that specific debtor under the applicable federal law on recording and priority that governs such Federal Intellectual Property Right.

(C) A security interest in a Federal Intellectual Property Right that has not been made subordinate under the preceding subsection has priority over such ownership transferee of such Right if and to the extent that such security interest meets the requirements for priority as provided under applicable non-federal law governing security interests in personal property.

(c) Federal Transfer Statements

(1) With respect to any Federal Intellectual Property Rights that are subject to a security interest (whether or not perfected) as to which the secured party has exercised its post-default rights or remedies, the person that is the transferee of such Federal Intellectual Property Rights as a result of such exercise of rights or remedies may file in the appropriate Federal record a transfer statement that:

- (i) states the name of the debtor and the name and mailing address of the secured party;
- (ii) identifies the Federal Intellectual Property Rights transferred;
- (iii) identifies, by file number the state financing statement previously filed by the secured party covering Federal Intellectual Property Rights.

(iv) states the name and mailing address of the transferee of the Federal Intellectual Property Rights (which may but need not be the secured party); and

(v) states that: (a) the secured party had a security interest in the Federal Intellectual Property Rights (and, in the case of Federal marks, in the goodwill of the business connected with the use of and symbolized by such Federal marks); (b) the debtor defaulted in connection with an obligation secured by the Federal Intellectual Property Rights and such default has not been cured; (c) the debtor has been given at least 5 days prior written notice of the transfer (which notice shall be deemed given if the secured party shall have complied with the notice requirements of applicable non-federal law in connection with the foreclosure upon, or other disposition of, collateral other than such Federal Intellectual Property Rights); and (d) the identified transferee of the Federal Intellectual Property Rights has complied with all requirements imposed by federal law as a condition to the effectiveness of a transfer of such Federal Intellectual Property Right and is entitled to the transfer of record of the interest of the debtor in the Federal Intellectual Property Rights transferred by reason of the secured party's exercise of its post-default rights or remedies in accordance with applicable non-federal law.

A transfer statement that identifies an intent to use application under 15 U.S.C. § 1051(b) among the Federal Intellectual Property Rights transferred may not be filed or recorded under this section unless the transferee is a successor to the business of the applicant debtor within the meaning of 15 U.S.C. § 1060(a). A transfer statement filed or recorded in violation of such prohibition shall have no force or effect on any of the Federal Intellectual Property Rights identified therein.

Recordation by a transferee of such a transfer statement in the appropriate federal record and in the manner required under applicable federal law (as amended by Section 4 of this Act) to give priority to such transferee's interest in the Federal Intellectual Property Right shall, if the transferee has complied with all other requirements imposed by federal law as a condition to the effectiveness of a transfer of such Federal Intellectual Property Right, serve as an effective document of transfer to the identified transferee, of the interest of the debtor and the secured party in the

Federal Intellectual Property Rights transferred. Such recordation of the transfer statement shall also be effective for all public record purposes under the appropriate federal recording requirement.

(2) Federal marks shall be transferable to the secured party in accordance with applicable non-federal law and under the preceding subsection even though such party does not engage in or intend to enter the business to which the Federal mark relates, provided that the secured party holds the Federal mark only for the purpose of subsequently transferring it along with the goodwill relating to the Federal mark, and that such subsequent transfer occurs [prior to the dissipation of the goodwill][within a period no longer than ___ months from the initial transfer].

(3) The Register of Copyrights, subject to the approval of the Librarian of Congress, the Commissioner of Patents and Trademarks, under the direction of the Secretary of Commerce, and the Plant Variety Protection Office shall promulgate final regulations to implement the federal transfer statement established by this subsection not later than ___ days after the date of enactment of this Act, and those regulations shall become effective not later than ___ days after the date of enactment of this Act.

(d) Federal Intellectual Property Data Center

The Secretary of Commerce in consultation with the Commissioner of Patents and Trademarks, the Register of Copyrights and the Plant Variety Protection Office shall establish the Federal Intellectual Property Data Center. The Federal Intellectual Property Data Center shall: (1) create and manage the National Integrated Financing Statement Database provided for under the next section and, (2) serve as a repository for such other information about Federal Intellectual Property Rights as is necessary or useful in carrying out the statutory or treaty obligations of the United States.

(e) National Integrated Financing Statement Database

The Secretary of Commerce shall maintain within the Federal Intellectual Property Data Center an internet accessible information database, or other electronic means for the coordination of information from various databases, that contains or serves as an electronic repository for financing

statements filed within the various states and available in electronic record form. [Filing offices within the various states shall cooperate with the Center in making their security interest databases available or accessible to the Center in electronic record form.] The database or databases so maintained or coordinated by the Center shall be adequate to search and identify security interests by the name of the debtor. The Center shall develop an electronic system to efficiently integrate the debtor name information in such database or databases with the names of immediate ownership transferors and ownership transferees that appear in the applicable federal intellectual property records.

(f) Fees

The fees for recording services in or through the National Intellectual Property Filing Center under this Act shall be established by the Secretary of Commerce.

(j) Regulatory Authority

The Secretary of Commerce shall promulgate final regulations to implement the functions of the Federal Intellectual Property Data Center and the National Integrated Financing Statement Database established under this Act not later than ____ days after the date of enactment of this Act, and those regulations shall become effective not later than ____ days after the date of enactment of this Act. The Federal Intellectual Property Data Center is authorized to maintain databases utilizing electronic, voice, optical, and other information transmission, storage, processing, maintenance and retrieval technologies. The Federal Intellectual Property Data Center shall also issue such other regulations as they determine to be appropriate to carry out the purposes of this Act, including regulations, if any, necessary and sufficient to permit submission and retrieval of information from the database(s) established pursuant to § 3(e).

**SECTION 4. CONFORMING AMENDMENTS TO STATUTES
DEALING WITH FEDERAL INTELLECTUAL PROPERTY RIGHTS**

(a) Copyright Act and Mask Works.

(1) Replace the existing definition of “transfer of copyright ownership” in 17 U.S.C. §101 with the following:

A “transfer of copyright ownership” is an assignment, exclusive license or any other conveyance or alienation of a copyright or of any of the exclusive rights comprised in a copyright, whether or not it is limited in time or place of effect, but not including a nonexclusive license or the grant of a security interest.

(2) Amend 17 U.S.C. §205(d) to read as follows:

(d) *Priority between conflicting transfers* - As between two conflicting transfers of copyright ownership, the one executed first prevails if it is recorded, in the manner required to give constructive notice under subsection (c), at any time before recordation in such manner of the later transfer. Otherwise the later transfer prevails if recorded first in such manner, and if taken in good faith, for value, and without notice of the earlier transfer. A lien creditor (whether real or provided for in hypothetical form under Title 11 of the United States Code) is not a transferee for value under the preceding sentence.

(3) Add a new 17 U.S.C. §205(f) to read as follows:

(f) Notwithstanding subsections 205(a)-(e), the provisions of section 205 shall not apply to the creation, attachment, perfection, effect of perfection, priority or enforcement of a security interest in a copyright or the proceeds thereof; no document creating, evidencing or otherwise relating to the creation or perfection of a security interest shall be required to be recorded under section 205; and the recordation of a document under section 205 shall

not give constructive notice of any fact relating to the existence or priority of any security interest; provided, however, that transfer statements submitted in accordance with section 3(c) of the Security Interests in Intellectual Property Restoration Act shall be recorded and once recorded shall give constructive notice under subsection (a) of the contents thereof.

(4) Amend 17 U.S.C. §903(c) to read as follows:

(c) (1) Any document pertaining to a mask work may be recorded in the Copyright Office if the document filed for recordation bears the actual signature of the person who executed it, or if it is accompanied by a sworn or official certification that it is a true copy of the original, signed document. The Copyright Office shall, upon receipt of the document and the fee specified pursuant to subsection 908(d), record the document and return it with a certificate of recordation. The recordation of any transfer or license under this paragraph gives all persons constructive notice of the facts stated in the recorded document concerning the transfer or license.

(2) Notwithstanding subsections 903(a)-(d), the provisions of section 903 shall not apply to the creation, attachment, perfection, effect of perfection, priority or enforcement of a security interest in a mask work or the proceeds thereof; no document creating, evidencing or otherwise relating to the creation or perfection of a security interest shall be required to be recorded under section 903; and the recordation of a document under section 903 shall not give constructive notice of any fact relating to the existence or priority of any security interest; provided, however, that transfer statements submitted in accordance with subsection 3(c) of the Security Interests in Intellectual Property Restoration Act shall be recorded and shall give constructive notice under subsection (a) of the contents thereof.

(b) Lanham Act

Replace 15 U.S.C. §1060 with the following:

§ 1060. Assignment of mark; execution; recording; purchaser without notice

A registered mark or a mark for which an application to register has been filed shall be assignable with the goodwill of the business connected with the use of and symbolized by the mark. However, no application to register a mark under section 1051(b) of this title shall be assignable prior to the filing of the amendment under section 1051(a) or the verified statement of use under section 1051(d) of this title, except to a successor to the business of the applicant, or portion thereof, to which the mark pertains, if that business is ongoing and existing. In any assignment authorized by this section or by section 3(c) of the Security Interests in Intellectual Property Restoration Act, it shall not be necessary to include the goodwill of the business connected with the use of and symbolized by any other mark used in the business or by the name or style under which the business is conducted.

Assignments shall be by instruments in writing duly executed. Acknowledgment shall be prima facie evidence of the execution of an assignment and when recorded in the Patent and Trademark Office the record shall be prima facie evidence of execution. An assignment (but not of a security interest in a registered trademark or an application to register) shall be void as against any subsequent purchaser for a valuable consideration without notice, unless it is recorded in the Patent and Trademark Office prior to such subsequent purchase. A separate record of assignments submitted for recording hereunder shall be maintained in the Patent and Trademark Office. An assignee not domiciled in the United States shall be subject to and comply with the provisions of section 1051(e) of this title. Except as provided in sections 3(b) and 3(c) of the Security Interests in Intellectual Property Restoration Act, the rights and obligations of all persons with respect to a security interest in a registered trademark, an application to register, or the proceeds of either, including matters of creation, attachment, perfection, effect of perfection, priority, and enforcement, shall be governed by non-federal law relating to security interests in personal property.

(c) Patent Act

Amend the last paragraph of 35 U.S.C. §261 to read as follows:

An assignment, grant or conveyance of a patent application or a patent (but not of a security interest in a patent application or a patent) shall be void as against any subsequent purchaser for value, without notice, unless it is recorded in the Patent and Trademark Office within ten days from its date or prior to the date of such subsequent purchase. Except as provided in section 3(b) and 3(c) of the Security Interests in Intellectual Property Restoration Act, the rights and obligations of all persons with respect to a security interest in a patent, a patent application, or the proceeds of either, including matters of creation, attachment, perfection, effect of perfection, priority, and enforcement, shall be governed by non-federal law relating to security interests in personal property.

(d)-(f) RESERVED FOR CONFORMING AMENDMENTS TO THE PLANT VARIETY PROTECTION ACT, 7 U.S.C. §2321 et seq, THE VESSEL HULL DESIGN PROTECTION ACT, 17 U.S.C. §501 et seq. AND CHAPTER 180 OF TITLE 28, U.S. CODE (ASSUMPTION OF CONTRACTUAL OBLIGATIONS RELATED TO TRANSFERS OF RIGHTS IN MOTION PICTURES)

(g) Accommodation of New Filing Technologies

All references in this Act and in the Lanham Act, the Patent Act and the Copyright Act to filings relating to security interests shall include electronic, voice, optical, and such other information transmission, storage, processing, maintenance, and retrieval technologies as shall be approved for such purposes by the Federal Intellectual Property Data Center, the Register of Copyrights, the Commissioner of Patents and Trademarks and the Plant Variety Protection Office from time to time.

SECTION 5. REPORT TO CONGRESS

The Secretary of Commerce shall report to the _____ Committee of the _____ not later than _____ days after the enactment of this Act regarding their plans to comply with the requirements of this Act.

SECTION 6. EFFECTIVE DATES

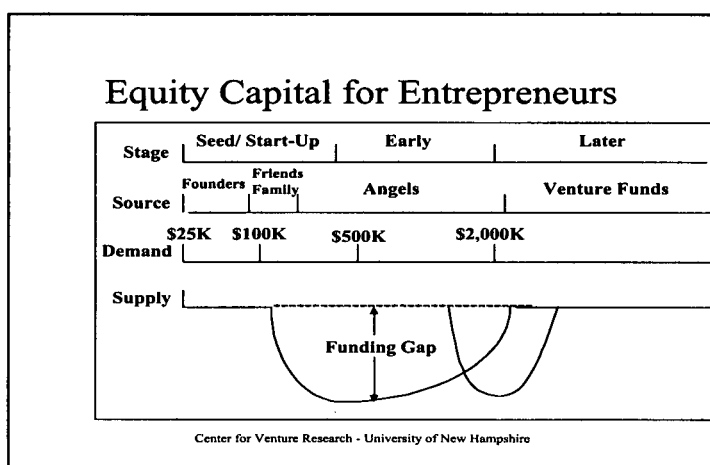
(a) This Act shall become effective on the date of enactment, except that the provisions of sections 3(c) shall not become effective until the effective date of the regulations described in section 3(c)(3) and the provisions of section 3(d)-(f) shall not become effective until the effective date of the regulations described in subsection 3(g).

(b) Section 3(b) shall apply to all security interests in effect under applicable non-federal law on the date of enactment.

APPENDIX 4 - MARKETS

A. Market Size and Scale

As illustrated in Figure 1, founders equity provides the small amounts of capital to begin the early stages of the proof of concept. Friends and family may also provide some of this initial concept development capital. However, for the inventor and entrepreneur, the angel investment represents the first external validity test and detailed due diligence on the innovation and the potential commercial viability of the invention. Currently, there are approximately 400,00 angels that invest between \$30-\$40 billion annually in around 50,000 entrepreneurial ventures. As the venture matures and begins to develop into a viable business that is producing products or services, professional venture capital funds become the primary source of capital.

Figure 1

Institutional venture capital investments, as shown in Table 1, have expanded rapidly since 1994. As the table indicates, venture capital investments in entrepreneurial ventures in the first two quarters of 2000 have already exceeded total investments for the year 1999. Average deal size (the amount invested per company) has also increased. These angel and venture capital investments represent a vital component for the new economy. While the number of start-ups that qualify for angel and venture capital investments are relatively small (less than 60,000 companies per year) and represent less

than ten percent of all the start-ups in a given year, most of the new jobs attributable to small firms are created by these relatively few firms that start small and grow fast. Since 1979, over 75% of net new jobs were created by these high growth start-ups (Birch et al. 1993). Over the last several years, this translates into these entrepreneurial ventures adding close to 6 million jobs to an economy that added 7.7 million in total.

Table 1

Venture Capital Funds			
Year	Total Amount	Number of Companies	Amount per Deal
1994	\$2.7 billion	1,000	\$2.7 million
1995	\$3.8 billion	1,128	\$3.4 million
1996	\$10.1 billion	2,163	\$4.6 million
1997	\$12.2 billion	2,706	\$4.5 million
1998	\$16.0 billion	2,692	\$6.0 million
1999	\$35.6 billion	4,006	\$8.9 million
2000 (1,2)	\$37.0 billion	2,855	\$13 million

Center for Venture Research - University of New Hampshire

The private investor and the institutional venture capitalist provide a range of markets through which an innovator or entrepreneur can seek to obtain financing to bring a product to market. It is how these markets function that determines the cost of capital to the innovator and entrepreneur. Markets provide a mechanism that strikes a price for a good or service. In some markets, especially in homogeneous commodities, the information needed to achieve this end is relatively straightforward. All market trading, however, involves taking a degree of risk. Most U.S. government bonds, although free of default risk, are not free of inflation risk. In other markets, a more complex valuation process may be required of individual market participants, who may not have full access to all information. At either extreme, individuals will make decisions based on their value estimates. In the stock market, this decision may be to continue to hold a particular stock, or to sell it, or to buy. In deciding whether to subscribe or lend money to enable the exploitation of a patent, investors would have to be satisfied, among many other matters, that their rights in relation to the patent will be protected.

It seems clear, however, that the existence of markets that are reasonably efficient, if not “perfect,” permits greater and low-cost access to the markets and stimulates interest, activity, and growth in those markets. Economic resources are allocated through the market mechanisms at prices that bring buyers and sellers together. Where there is a lack of information, and high transaction costs, the progress of the market is inhibited.

B. Scarcity, Choice and Efficiency in the Market

The discipline of economics, as noted earlier, is founded on the principle that goods and services are scarce relative to the need for them; and that scarcity demands a price. The relative scarcity of resources leads to the need to choose among competing uses. For example, assume that steel is used only in making washing machines and cars. The use of a ton of steel in car making deprives washing machine making of that ton of steel. The cost (the “opportunity cost”) of the ton of steel to car making is the cost of the steel in its next best alternative use, the manufacture of washing machines. Often, this opportunity cost will be reflected closely in the market price of steel; how closely, will depend on the efficiency of the market for steel.

Economists define efficiency as the absence of wasted resources, such that an economy maximizes its output from a given input and a given state of technology. In making the decisions to allocate scarce resources, therefore, the economy, or perhaps more appropriately society, must make three closely-related decisions:

1. How to allocate its resources efficiently.
2. What combination of goods and services to produce.
3. How much of each good and service to distribute to individual members of society.

Using resources efficiently means maximizing output from a given input, or minimizing input for a given output. It is necessary to long-term economic survival, however, to produce those goods and services that society requires. Who should receive the goods and services produced is a distribution decision that will be left aside for the present purposes.

The efficiency benefits of specialization within an economy was first formally identified by Adam Smith in his “Wealth of Nations,” in relation to the division of labor and using the example of pin-making:

“One man draws out the wire, another straightens it, a third cuts it, a

fourth points it, a fifth grinds it at the top for receiving the head; to make the head requires two or three distinct operations; to put it on is a peculiar business, to whiten the pins is another; it is even a trade by itself to put them into the paper; and the important business of making a pin is, in this manner, divided into about eighteen distinct operations, which, in some manufactories, are all performed by distinct hands, though in others the same man will sometimes perform two or three of them. I have seen a small manufactory of this kind where ten men only were employed, and where some of them consequently performed two or three distinct operation . . . Those ten persons . . . could make among them upwards of forty-eight thousand pins in a day. Each person, therefore, making a tenth part of forty-eight thousand pins, might be considered as making four thousand eight hundred pins in a day. But if they had all wrought separately and independently, and without any of them having been educated to this peculiar business, they certainly could not each of the have made twenty, perhaps not one pin a day; that is, certainly, not the two hundred and fortieth, perhaps not the four thousand eight hundredth part of what they are at present capable of performing, in consequence of a proper division and combination of their different operations.”¹

Smith, in the above passage, described *how* goods might be produced more efficiently, but did not discuss the fact that efficiency may be influenced also by *which* goods are produced. This aspect of efficiency may be studied by means of the “theory of comparative advantage.” People, firms and countries differ in their ability to produce particular goods and services efficiently, and thus may benefit by specializing where they have a comparative advantage, and then exchanging some or all of the fruits of their labors for other goods and services. For example, country A may be much more efficient at producing telephones and somewhat more efficient at producing trucks than country B. It will be more economically efficient for A to produce telephones and B to produce trucks, and for A and B to trade in these goods, than for country A to make both goods. Put another way, it will be economically efficient for B to make trucks because it is comparatively less inefficient than A in truck production than it is in telephone production as compared to A.

¹ Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, 1776; Dent, London, 1910, p. 5.

C. *Exchange, Markets and Money*

Specialization gives rise to exchange. Smith introduced the concept of exchange in another well-known passage:

“Nobody ever saw a dog make a fair and deliberate exchange of one bone for another with another dog . . . But man has almost constant occasion for the help of his brethren, and it is vain for him to expect it from their benevolence only It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages. Nobody but a beggar chooses to depend chiefly upon the benevolence of his fellow-citizens.”²

The institution of the market enables an exchange to occur, with one person exchanging goods or services for the goods or services offered by another. Negotiation between the two establishes a rate of exchange between the quantities of the goods and services to be traded or bartered. Such a bartering arrangement, however, requires a “double coincidence of wants,” such that, at a given moment in time, the first person has exactly what the second person wants, and *vice versa*. In practice, this is unlikely to occur, and so the “value” of goods and services began to be expressed in terms of a common standard or measure.

This measure, which we know as “money,” is the result of market negotiation that establishes rates of exchange between and among goods and services. This rate of exchange in money terms may disappear as soon as the particular exchange has been consummated. If, however, information about the exchange becomes widely known within the market for these goods and services, details of the exchange may be taken into account by other market participants, thus leading to the recognition of “market” prices for the goods and services traded.

In the extreme case, the so-called “perfect market,”³ no single seller is able to charge and obtain a higher price than any other; all must accept the market price. Further, one person may accept money in exchange for goods or services, and then use that money, now or later (in this case money becomes a “store of value”), to buy goods and services from one or more other persons. D.H. Robertson stated:

² *Idem*, pp.12-13.

³ See below for a more detailed explanation of the “perfect market” concept.

“The first great achievement of money is that it enables man as consumer to generalize his purchasing power, and to make claims on society in the form which suits him best The second great achievement of money is that it enables man as producer to concentrate his attention on his own job, and so to add more effectively to the general flow of goods and services which constitutes the real income of society . . . The third great achievement of money is closely allied to the second . . . [M]oney immensely facilitates the making of loans and payments in advance of all kinds.”⁴

D. Markets and Other Institutions

Markets occupy a pre-eminent place in economics. The “substitutes” theory in economics takes the view that markets and certain other institutions (notably governments, the law, households and firms) are necessary for economic activity, but that the market is the primary institution, and other institutions are secondary.⁵ Under the substitutes theory, “firms, government, and other forms of organized economic activity are deviations from and substitutes for competitive markets.”⁶ The sequence of arguments under the substitutes theory is that the market is the primary economic institution, because competitive markets are the “most efficient organizers of economic activity.”⁷ If the market fails, then an institution, often a government, will intervene to prevent or mitigate the effects of market failure, through such measures as welfare programs, fiscal policy, and the regulation of financial institutions and markets. If government intervention fails, then fundamental institutional change may be necessary to achieve a restructuring of the relationship between government and the economy. This restructuring may lead, for example, to deregulation, welfare reform, and policies designed to reduce the size of the government sector.

As noted earlier, however, markets and governments are not the only institutions involved in economic activity. Others include households, the law, and firms. Firms exist as institutional responses to the failure of

⁴ D.H. ROBERTSON, *MONEY*, Cambridge University Press, 1922, pp. 4-8.

⁵ For a much more complete discussion of these issues, see J.R. Wible, “*The Economic Organization of Science, the Firm, and the Marketplace*,” *PHILOSOPHY OF THE SOCIAL SCIENCES*, Vol. 25, No. 1, March 1995, pp. 35-68.

⁶ Wible, *idem*, p. 38.

⁷ Wible, *idem*, p. 40.

markets efficiently to organize economic resources⁸ for the purposes of creating, producing and distributing goods and services. R.H. Coase identified three principal transaction costs in a market:

1. Information costs, that is, the costs of acquiring of information about market prices and price movements.
2. Negotiating costs, concerned with the initiation and analysis of contracts.
3. Short-term risk costs, that may be reduced by creating a longer term organizational structure, that is, a firm.

Coase wrote:

“The operation of a market costs something and by forming an organization and allowing some authority (an “entrepreneur”) to direct the resources certain marketing costs are saved. The entrepreneur has to carry out his function at less cost . . . because it is always possible to revert to the open market.”⁹

⁸ Known to economists as “factors of production.” Originally, these were three: land, labor and capital. The “organization” factor of production, “entrepreneurship,” was added by Alfred Marshall about 100 years ago.

⁹ R.H. Coase, *The Nature of the Firm*, *ECONOMICA* (New Series) Vol.IV, 1937, pp. 386-405, reprinted in *Readings in Price Theory*, AMERICAN ECONOMIC ASSOCIATION, Allen & Unwin, London, 1953. Quotation from the AEA reprint, p. 338.

APPENDIX 5 – THE SECONDARY MARKET FUNCTION

THE SECONDARY MARKET FUNCTION-DEBT TRANSACTIONS

Securitization is an attractive financing alternative to equity transactions for a variety of reasons and is a potential market for the entrepreneurs who seek to leverage the value of intellectual property. Securitization allows a borrower to separate its credit from the credit of the assets to be securitized. The assets with potential to generate income are pooled and securities are sold to finance the carrying of the pooled assets. The securities market then analyzes the creditworthiness of the assets, rather than the creditworthiness of the borrower. This can result in reduced risk to the investor and lower costs of capital to the borrower.

Bissonette and Andersen set out the securitization process in four steps:¹

1. The originator identifies an asset with a reasonably predictable cash flow, often some type of receivable.
2. The originator sells the asset to a newly formed, legally separate entity known as a special purpose vehicle (“SPV”). The sale of assets is structured as a “true sale.” The SPV raises funds to purchase the asset by issuing securities to investors through the capital markets.
3. The SPV structures the securities to be sold according to such criteria as the past performance history of the asset and the degree of credit enhancement, leading to a credit rating and thus the interest rate assigned to the securities. “The goal here is to structure the securities in such a way as to provide ample protection to the investors while still paying a profitable amount to the originator.”
4. The SPV enters into “pooling and servicing agreement” with a third party, who agrees to service the obligations now owned by the SPV. Often, the third party is the same entity—the originator—that sold the asset to the SPV. The service provider

¹ A.M. Bissonette and R.M. Andersen, *Securitization: Turning Future Receivables into Cash*, PACESETTER MAGAZINE, Ontario Systems, Fall 1998, pp.24-27.

collects payments from debtors, remits payments to investors, reports to investors, and accounts for interest and principal throughout the life of the securities issued.

Jason Kravitt argues that definitions such as the above are orientated towards process rather than substance. He prefers a more fundamental definition of securitization: “[Securitization] consists of the use of superior knowledge about the expected financial behavior of particular assets, as opposed to knowledge about the expected financial behavior of the originator of the chosen assets, with the help of a structure to finance the assets more efficiently.”² Javitt emphasizes the separation of the behavior and characteristics of the originator from the behavior and characteristics of the assets. The breakdown of individual, segregated, and protected capital markets into an increasingly worldwide capital market, Javitt believes, has driven the need to find more and more efficient means of raising capital. With the greater use of computer technology and the information revolution, securitization has become among the most efficient financing forms. Computers allow the storage and retrieval of data on the historical behavior of asset pools, thus enhancing knowledge of the subsequent behavior of earlier asset pools from a given originator. Done correctly, says Javitt, securitization of the asset pool can be less risky than the direct financing of the originator. The “correct” securitizing of an asset pool requires several structural components: the isolation of the assets, by “true sales,” from the originator to render them “bankruptcy remote” from the originator. This ensures that the only relevant event to the financial success of the investment is the behavior of the assets; the perfection of the asset investors’ interest in the assets; and the limitation of the investors’ liability.³

Securitization is a response to market conditions, and especially to increased market efficiency, globalization, and the increasingly rapid dissemination of data. It has been applied to a variety of different situations and could potentially be applied to future income stream from intellectual property. In what follows, residential mortgages, credit card debt outstanding, ship mortgages, Bowie bonds, ALPS, and junk bonds are discussed. Each of these offers a somewhat different aspect of the fundamental financial relationships among risk, return, and value. In all, the objectives are to release the capital value of projected future income streams; to develop secondary markets to improve liquidity; and to use portfolio

² Jason H.P. Kravitt, *Securitization*, THE FINANCIER, Vol. 4, No. 5, December, 1997, pp. 7-11.

³ *Id.* at 8.

diversification to reduce the impact of the default risk present in securities issued by individual companies. These same goals are applied when looking to create markets for entrepreneurs and innovators who seek to leverage intellectual property assets.

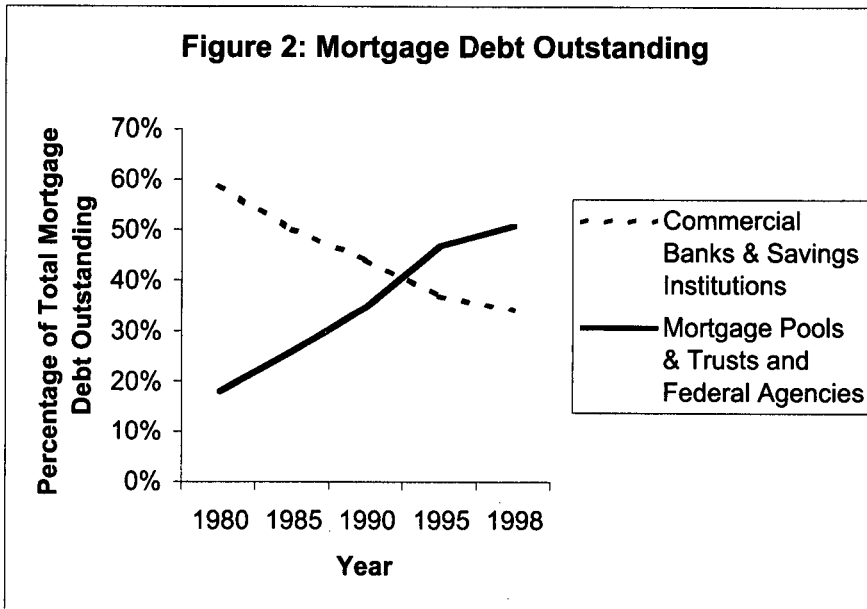
A. The Secondary Market Residential Mortgages

A well-known example is the secondary market in residential mortgages. At one time, banks held residential mortgages in their own investment portfolio. Today, many banks bundle, or “pool” and sell the mortgages to other institutional investors seeking a well-secured medium to long term income stream, thus immediately releasing funds to the banks for further mortgage activity. The following table shows the change in the composition of mortgage holders (mortgagees) for selected years between 1980 and 1998:

Table 1: Composition of Mortgage Holders

	1980	1985	1990	1995	1998
Mortgage Debt Outstanding (\$ billions)	<u>1,465</u>	<u>2,374</u>	<u>3,794</u>	<u>4,610</u>	<u>5,782</u>
Commercial Banks and Savings Institutions	59%	50%	44%	37%	34%
Life Insurance Companies, Individuals and Others	23%	25%	22%	16%	15%
Mortgage Pools or Trusts	10%	18%	28%	40%	45%
Federal Agencies	<u>7%</u>	<u>7%</u>	<u>6%</u>	<u>7%</u>	<u>5%</u>
Total	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>
Source: Statistical Abstract of the United States, 1999, U.S. Department of Commerce, Table 820, p. 525.					

The shift of mortgage holders from commercial bank and savings institutions towards mortgage pools and trusts (including federal agencies) may be shown graphically (see Figure 2):



Between 1980 and 1998 the mortgage debt outstanding, in money terms, increased fourfold (see Table 1). Yet the proportion of the debt held by the principal mortgage initiators, commercial banks and savings institutions, fell from almost 60 per cent to just over 34 percent. During the same period, mortgage debt held in pools or trusts, having been sold by the banks on the secondary mortgage market, increased from 10 percent to over 45 percent of the mortgage debt outstanding. The banks' need for liquidity in order to take advantage of new lending opportunities provided the motivation; the prospect of a steady and secured income stream motivated investors; and the standardization of mortgage terms and criteria made possible the bundling and securitization of mortgage debt for sale on the secondary market. Similarly, bank and credit card companies sell on the secondary markets asset-backed loans such as credit card receivables or consumer installment loans.

The mechanism in each case usually requires the sale of the assets to a pool or trust, in which investors buy a security interest. Often, the originator of the loan (for example, the bank) will continue to collect payments from the debtor, and take a processing fee, passing the net proceeds to the investors in the security. The originator of the loan must ensure that the credit-worthiness of the borrower and the terms of repayment of interest and principal conform to strict standards, otherwise the loan will not be accepted as a pooled security. The mere pooling of such assets for

sale, however, is not always sufficiently attractive to potential investors. It becomes necessary, therefore, to “sweeten” by the deal, at additional cost, using “credit enhancement” techniques. Credit enhancement may take a variety of forms, notably guarantees, credit downgrade triggers, offsetting obligations amongst the parties, and/or additional collateral security, all with the intention of improving the credit rating of the investment, thus increasing its marketability and hence its value.

B. The Secondary Market for Credit Card Debt

The credit card market in the U.S.A. has increased from \$234 billion of total receivables outstanding in 1990 to \$356 billion in 1998.⁴ The growth came from continued reliance of consumers on credit cards, more acceptance of credit cards by merchants and service providers, and a greater diversity of cards, including affinity and co-branded cards. Eight of the top ten institutions with credit card portfolios accounted for approximately two-thirds (\$240 billion) of the \$356 billion credit card debt outstanding in mid-1998. Over 60 percent of the \$240 billion was securitized. The percentage of debt securitized by individual institutions in the eight ranged from 49 percent to 75 per cent.⁵

The use of securitization as a financing tool has increased since the first securitization deals were made in 1987, primarily in order to diversify sources of bank funding. In the middle to late 1990s, securitization has become the primary source of funding for specialized credit card banks such as Fleet, Citibank, MBNA and First USA. These banks benefit from funding at the favorable rates implied by high, AAA, grades, and use securitization to remove debt from their balance sheets.⁶ Dean *et al.* observed “Without securitization, some of these banks could not have grown as rapidly.”⁷

Most credit card securitizations have used the master trust vehicle since 1991, rather than the more cumbersome “stand alone” approach used until then. The master trust is more flexible, in that it permits the issuer to sell multiple securities from the same trust, all of which are secured on the

4 Michael R. Dean, Chris Mrazek, Richard C. Drason, Mark Sun, Kathy Moon and Michelle Galvez, *ABCs of Credit Card ABS*, THE SECURITIZATION CONDUIT, Vol. 2, No. 2 & 3, 1999, pp.26-37.

5 *Id.*, Exhibit 1, pp. 27-28.

6 *Id.* at 27.

7 *Id.* at 28.

same pool of receivables - "All the accounts support all the securities."⁸ This enables the issuer to add new receivables to the trust, and then to issue new securities against them, and thus avoids the costs of setting up a new trust for each issue (as required by the stand alone trust). The master trust is a particularly suited to credit card securitization, as credit card debt outstanding is constantly changing in both total amount and composition.⁹ From the perspective of the investor, however, the asset composition of the master trust will be changing constantly, and with it, perhaps, the risk complexion of the pooled assets. Every seller of credit card debts to the trust is required both to issue securities and to maintain an ownership interest in the trust (usually at least 7 percent), so that the seller will have a direct interest in maintaining the credit quality of the pool.

Credit card debt, being unsecured and revolving, offers no collateral in case of default. The ability to recover the debt in default is limited, and this does not present an attractive investment opportunity to investors seeking investment-grade securities. Once again, therefore, credit enhancement is needed, and takes the form of some combination of elaborate customer credit scoring models, "excess spread," and "reserve" accounts financed by subordinated debt.¹⁰ Excess spread is described in detail in Dean, *et al.* Credit card debt has a high yield, around 18 per cent. This revenue must, for example, cover the coupon payments to investors, 7 per cent; servicing expenses, 2 percent; and defaults, 5 per cent, a total of 14 per cent.¹¹ The remainder, 4 percent, is the excess spread, and is a rough indicator of the health of the portfolio. It may be used in a variety of ways to enhance credit: as a safety margin of value to investors; as profit to issuers; and/or as a "sweetener" to investors.

C. *The Ship Mortgages Act*

"Throughout history, trading nations have consistently felt that a merchant fleet was important to their economic well-being and have enacted

⁸ *Id.* at 28.

⁹ The average life of a credit card receivable is only five to ten months. Contrast this with residential mortgages with average lives of around eight years.

¹⁰ As in the case of ALPS (*q.v.*), credit enhancement is achieved in part by passing the default risk burden downstream to subordinated debt.

¹¹ These figures are illustrative, although they are probably fairly close to current experience. Default rates seem to have risen towards 6 per cent, and service costs have increased also, reducing the average excess spread to the 2-4 percent range.

various measures to encourage national merchant marines.”¹²

In 1914, only about 10 percent of U.S. international trade was carried in U.S.-flag ships as its merchant marine had concentrated mostly on domestic coastal trading. Consequently, most of U.S. international trade was carried by British, German, Italian, and French ships. At the outbreak of the First World War in 1914, these nations were belligerents, and diverted their merchant fleets for strategic and naval purposes. The paralyzing effect of the withdrawal of these ships from U.S. commerce led to the 1916 Shipping Act. This act established a five-person Shipping Board with broad powers to encourage and expand the U.S. shipbuilding program.¹³ As a result of the Board’s activities, the U.S. emerged from the First World War with

“the world’s largest merchant fleet Most of this fleet was owned by the government, which had no desire or mandate to operate it in peacetime trade beyond the five years after the war’s end provided for in the 1916 act.”¹⁴

The extent of the problem may be seen in Table 2:¹⁵

Table 2

Deliveries to Shipping Board (non-naval vessels, deadweight tonnage)							
1914	1915	1916	1917	1918	1919	1920	1921
200,000	200,000	600,000	1,000,000	3,000,000	6,200,000	3,100,000	800,000

To deal with this problem, the 1920 Merchant Marine Act was passed (the Jones Act), which provided for the transfer of the Board’s fleet to private hands in such a manner that it could be operated profitably. In the same year, 1920, the Ship Mortgage Act was passed. Prior to this act, a ship mortgage was held not be a maritime contract, and so could not be enforced in maritime courts, although common law did offer very limited protection to the creditor. F.L. Maraist wrote:

“The lack of an adequate device by which a ship-owner could

¹² Congress of the United States, Congressional Budget Office, “U.S. Shipping and Shipbuilding Trends and Policy Choices,” August, 1984, p.33.

¹³ *Idem*, p.12.

¹⁴ *Idem*, p.12. In 1920, the U.S. owned 22 percent of the world’s shipping capacity, compared to just 7 percent in 1914.

¹⁵ F.C. LANE, SHIPS FOR VICTORY: A HISTORY OF SHIPBUILDING UNDER THE U.S. MARITIME COMMISSION IN WORLD WAR II, The Johns Hopkins Press, Baltimore, 1951, p.5. Note that deliveries did not peak until the year after the end of the war.

borrow on the credit of the vessel undoubtedly discouraged private financing of vessels. In 1920, Congress, in an effort to develop a stronger American merchant marine and, perhaps to facilitate disposal of the merchant vessels which the federal government had acquired during World War I, passed the Ship Mortgage Act . . . , providing for a ‘preferred ship mortgage’ on a vessel and for its enforcement in an *in rem* proceeding in admiralty The Ship Mortgage Act has become a vital part of the financing of American maritime shipping.”¹⁶

The Ship Mortgage contained the following main provisions:¹⁷

1. A maritime preferred mortgage can be granted only on a “documented vessel.”
2. The mortgage must be on the whole vessel.
3. The mortgagee must be a U.S. citizen or other designated entity.
4. The mortgage may include more than one vessel and may include non-maritime property.
5. There is no limitation on the interest rate charged.

The perfection of a preferred¹⁸ ship mortgage requires the following steps:

1. The execution of a mortgage, with acknowledgement.
2. The mortgagor “*may be required to disclose the existence of obligations on the mortgaged vessel and may not incur certain liens on the vessel until the mortgagee has had a reasonable time to record his preferred mortgage.*”
3. The mortgage must be lodged with the Secretary of Transportation, who must maintain “*an appropriate index of mortgages for use by the public.*”

¹⁶ F.L. MARAIST, ADMIRALTY, NUTSHELL SERIES, West Publishing Group, 3rd Edition, 1996, pp. 82-83.

¹⁷ *Idem*, p.84.

¹⁸ There were some restrictions on the term ‘preferred.’ “The maritime ship mortgage is primed by all maritime liens arising prior to the recordation of the mortgage, and by all subsequently arising maritime liens except those securing maritime contracts.... Because of this, the mortgagee may require that all pre-existing liens be paid before funds are advanced under the mortgage and that no other contract liens be placed on the vessel before the mortgage is recorded.” *Idem*, pp. 84-85.

4. The mortgagor shall use "diligence in keeping a certified copy of the mortgage on the vessel."¹⁹

It seems clear that the act was intended to stimulate the private financing of mortgages by seeking to ensure that information regarding prior liens was made available to prospective mortgagees, who in turn were obliged under the act to register their mortgage with the Secretary of Transportation. Also, copy of the mortgage had to be attached to the asset itself, as a further safeguard.

By 1922, events had overtaken the act. The demand for shipping collapsed, and 17 percent of the world's capacity was idled, and the war-built U.S. fleet began to be steadily out-performed by other, more modern fleets. The 1936 Merchant Marine Act was a response to this situation. It established the U.S. Maritime Commission to replace the Shipping Board, and provided for the financing and production of a U.S. made and crewed merchant marine. The Second World War gave an added stimulus to shipbuilding (see Table 3), based on the 1936 act. In consequence, the U.S. merchant marine emerged from the Second World War with about 4,500 ships suited to commercial use, more than all other nations combined.

As had occurred at the end of the First World War, the end of the Second World War saw the need to dispose of the ships that had been built to meet the strategic requirements of the war.²⁰

Table 3

Deliveries in Maritime Commission Program (non-naval vessels, deadweight tonnage)						
1939	1940	1941	1942	1943	1944	1945
250,000	500,000	750,000	8,000,000	19,000,000	16,500,000	11,000,000

The Merchant Ship Sales Act of 1946 provided for the sale of these ships to U.S. citizens and foreigners. Some 2,000 were sold, with a further 1,400 being laid up in the National Defense Reserve Fleet.²¹ In addition, the Ship Mortgage Act of 1920 was amended to cover foreign ship mortgages:

"After World War II, the United States sought once again to

¹⁹ *Idem*, p. 84, emphasis added.

²⁰ F.C. Lane, *op.cit.*, p. 5. Note that production peaked in 1943, about a year after the United States entered the war, which had been in progress since 1939. Contrast this with the First World War numbers, above.

²¹ Congress of the United States, *op. cit.*, p.p.16-17.

dismantle its merchant fleet, but found that the increasingly popular use of foreign flags of convenience required expanding preferred mortgage status to foreign ship mortgages Congress amended the act to cover foreign mortgages, but the procedural requirements for domestic mortgages were not imposed. Instead, the Act viewed the foreign mortgage in the light of the applicable foreign law.”²²

National emergencies were responsible for the major changes introduced into the financing of shipbuilding in the 1920s and 1940s. Outdated laws and the consequent poor quality of available information were unnecessarily restricting the willingness and ability of investors to finance shipbuilding. The laws enacted strengthened the rights of the creditor, the mortgagee, by opening up the possibility of a preferred mortgage, and particularly by requiring that data about the mortgage be documented and recorded in a central database held by the Secretary of Transportation. While none of these enactments did much directly to improve the liquidity of investors, it did encourage those investors to become mortgagees by clarifying the extent of their risk, at least as far as default risk and prior claims are concerned. In this sense, they provided a necessary but not a sufficient condition for the development of a secondary market that would improve investor liquidity and reduce investor risk.

D. The Securitization of Future Income Streams

David Bowie, the entertainer, was a pioneer in the securitization of a future income stream. In 1997, Pullman and Associates struck a deal with Prudential Investments to pay \$55 million on ten-year notes to Bowie, with the repayment backed by royalties generated from a twenty-five record catalog of his work.²³ David Pullman, whose firm brokered the Bowie deal, believes that there is an untapped market of such deals that amounts to \$100 billion of annual licensing cash flow, which translates into a capitalized value of around \$3 trillion. The object of securitization by artists such as Bowie is to gain liquidity by capitalizing future cash flows. The assets backing the securities, however, are tied up for around ten years, and so cannot be used to secure future security deals until the initial deal is paid off. Contrast this with a credit-card deal for example, which tends to be somewhat generic and can be updated, with additional financing, on a

²² Federal Reporter, F.2d. Series, Vol. 776, 1986, West Publishing Co., p. 86.

²³ Lynna Goch, *op. cit.*

quarterly basis. Further, most artistic property is unsuited to long-term securitization: 99 percent of entertainers receive 95 percent of their royalty income within six months of the initial release of their work. Securitization deals, therefore, are only for those artists whose work has a proven record of long-term success. These deals are not “cookie-cutter” deals, according to Pullman.²⁴ Rather, as private placements not public issues, they require intensive negotiation that is based upon substantial research and study.

Investors – mostly insurance companies – have a mixed view of intellectual asset-backed securities. “Intellectual asset-backed securities are illiquid. Not many people know about them. The universe of buyers and sellers of this type of business is small,” says Douglas McCoy of Conseco Capital Markets.²⁵ Insurance companies need to be able to adjust their portfolios in line with changes in the market and in their liabilities. On the other hand, they are looking for well-secured, long-term investments with reliable cash inflows. Thus, they are willing to incorporate asset-backed securities into their portfolios, but only to a limited extent, knowing that they would have difficulty in disposing of any holdings rapidly and at low cost.

E. Aircraft Leasing Portfolio Securitization

Assets such as credit card debt and mortgages may be bundled together and securitized relatively simply, as their terms can be standardized, and none of them is, individually, likely to involve an amount in the millions of dollars. For assets individually worth large sums of money, such as a passenger jet aircraft, the terms are far more likely to be one-off and specially tailored to the needs of specific borrowers and lenders. In the case of aircraft leasing, the assets comprise both airplanes and leases. Commonly, the aircraft are sold to a “special purpose entity” (“SPE”), also known as a “special purpose vehicle” (“SPV”), which then issues new securities on the aircraft.

“Aircraft are generally characterized as ‘dangerous assets’. They are expensive to buy and operate, they are rarely in one place for very long, they become subject to a wide variety of laws and jurisdictions, they cause enormous damage when they crash, and they cause pollution. Worst of all,

²⁴ *Id.*

²⁵ *Id.*

people lose money on them.”²⁶

The potential market, however, is large, and with the decline of airline credit quality in the last decade or so, it has proved to be increasingly difficult for individual airlines to lease new aircraft, and then only as private placements rather than publicly traded securities. The use of securitization by grouping a number of airlines together and pooling their leases has diversified the portfolio. This, in turn, has lowered risk and made the cost more attractive to the airlines than a conventional lease, and the risk-return characteristics more attractive to investors.²⁷ William C. Bowers writes:²⁸

“Rather than enhancing a single corporate credit, the ratings of the debt securities issued in a portfolio securitization are based on the existence of a worldwide aircraft leasing market and the projected residual values of the aircraft in the portfolio. The actual levels of the ratings depend on a number of factors, including the age, initial value and diversity of the aircraft in the portfolio, the diversity (both individually and geographically) of the lessees of the aircraft and (to a much lesser extent) their credit quality, the initial level of lease rents, assumptions as to the timing and costs of defaults and remarketing and other relevant factors. Credit support in a portfolio securitization is tailored to the particular needs of the aircraft and lessees involved, e.g., . . . major maintenance costs, compliance with noise regulations and similar factors.”

The first ALPS issue occurred in 1992, amounting to \$417 million of debt and based on an appraised value of \$521 million. It was subjected to a very high degree of due diligence:

“Each country in which a lessor was located was completely vetted from a legal standpoint, and each lease was carefully reviewed to ensure that it met exacting legal standards. A similarly high legal standard was applied in the actual aircraft deliveries, resulting in an extended period between

²⁶ Robert Hallam, “Securitization,” *THE FINANCIER*, Vol. 2, No. 3, August, 1995, p. 52.

²⁷ *THE TIMES*, LONDON, *Securities take off with bonds based on aircraft leases*, June 15, 1992; and *THE FINANCIAL TIMES*, LONDON, *Securitisation: a viable financing option – International*, August 24, 1994. Note, however, that in the case of the 1992 ALPS, credit enhancement for the Senior Notes was essentially at the expense of the subordinated debt. See Hallam, *op. cit.*, p.58, “Packing in collateral and credit enhancement to satisfy senior debt ratings doesn’t solve problems – it merely shifts them downstream. Placing subordinated debt is much harder than finding investors for AAA notes.”

²⁸ WILLIAM C. BOWERS, “AIRCRAFT LEASE SECURITIZATION: ALPS TO EETCS,” Winthrop Stimson Law Office, New York, nd., p.1.

initial funding and the transfer of the last aircraft.”²⁹

The second ALPS issue, in 1994, was an SEC registered securitization of a portfolio of aircraft operating leases and involved almost \$1 billion of debt on an appraised asset value of over \$850 million, about twice as much as the first portfolio securitization. Twenty-seven aircraft were leased to 22 lessees in 14 countries. There followed an issue of over \$4 billion to finance 229 aircraft to 83 lessees in 40 countries.³⁰

The success of the ALPS issue led bankers to consider whether securitization might be applied to an individual airline rather than a bundle of airlines, and this resulted in the creation of the Enhanced Equipment Trust Certificate (“EETC”). As the term implies, these securitizations are enhancements to more traditional equipment trust certificates. The enhancements may include: the issuer of the EETC being “bankruptcy-remote” from the lessee; the existence of a direct relationship between the expected residual value of the aircraft and the amount of funding – the lower the funding percentage, the higher the credit rating; and the existence of a liquidity facility to ensure the continued payment of interest on EETCs during the repossession and remarketing of the aircraft lease following default by the lessee. The first EETC was by Northwest Airlines in 1994, and was followed by several others through 1997 that involved over 90 aircraft and \$3.3 billion in debt.³¹ The website of Monitor Leasing and Financial Services lists a number of recent transactions involving such companies as Pegasus, GE Capital Aviation Services, CIT Aerospace, ILFC, and Aerolease.³²

F. Junk Bonds

The “junk bond” financial scandal of the 1970s and 1980s offers an intriguing, if perverse, view of the importance of liquidity and marketability to value. Michael Milken, the junk bond “king,” believed that there was an inefficiency in the corporate bond market. Milken discovered that many

²⁹ *Idem*, p.2. Hallam, *op. cit.*, pp. 55-56, stated that “the logistical problems in effecting title transfers and the creation of security interests have to be gone through with each Aircraft and Lease, which.....required four months of hard work with 14 sets of conditions precedent and nearly 100 legal opinions.”

³⁰ *Idem*, p. 2.

³¹ *Idem*, pp. 1-3.

³² www.monitordaily.com/news/aircraft.html.

defaulted or lower-rated bonds were under-priced in the markets relative to their risk. This under-pricing relative to risk offered the potential for a portfolio of such bonds to out-perform a portfolio of investment grade bonds. In an efficient market, U.S. Treasury Bonds with no default risk would have yielded (because of a price differential) the same amount as the bonds of companies “in distress” with their much higher interest rates but also higher rates of default. Benjamin J. Stein wrote:

“The buyers of the bonds were helped because the bonds were crafted to pay a yield so high that even after deducting for the defaults that would inevitably occur, the bond buyer would still be ahead of where he would have been if he had bought boring old Treasury bonds with their nil default rate and their lower yields The borrowers were better off because with the proceeds of the Drexel junk debt, they could apply their ingenuity, their talent, and their own innovations to make their businesses grow The American worker was better off because the companies funded by Drexel would provide new jobs while the old, stodgy, investment-grade American companies got smaller and laid-off workers The American consumer was better off because Drexel issuers would provide new kinds of goods and services, such as larger and better casinos and nationally franchised day-care centers America as a nation was better off because thanks to Mike Milken the republic was more prosperous and freer in several basic ways. Access to capital was now democratic. If any American had a good idea, he could bring it to Milken, get it funded, and tries his hand at capitalism . . . Capital would not be provided only to rich WASPs of old family, but on the basis of the aristocracy of talent.”³³

Milken had a point: Only corporations with “investment grade” bonds (some 5 percent of the 23,000 U.S. companies with annual sales in excess of \$35 million) had access to long-term debt capital. The remaining 95 percent were either left without debt funding opportunities, or were forced into higher cost debt financing from the banks. Post-Milken, markets in lower grade bonds have developed, so that, at a price, high-risk companies have easier access to long-term debt finance.³⁴

If this inefficiency in the market existed and led to under-pricing of high risk, “junk” bonds, then, wrote Stein:

³³ BENJAMIN J. STEIN, *A LICENSE TO STEAL: THE UNTOLD STORY OF MICHAEL MILKEN AND THE CONSPIRACY TO BILK THE NATION*, Simon & Schuster, New York, 1992., pp. 22-23. This section draws heavily on Stein’s work.

³⁴ See GLENN YAGO, *HOW HIGH YIELD SECURITIES RESTRUCTURED CORPORATE AMERICA*, Oxford University Press, 1990.

"It meant that buyers of low-rated bonds could, with some insignificant investment of time and effort, consistently achieve higher yields at this lower end of the bond scale than at the higher end. The increased default rate of poor-quality bonds would not be so large as to offset their higher yield. "Junk," in fact, would be, if carefully bought, more valuable than gilt-edged Treasury bonds. The high interest rate of such bonds would, over time and with a large enough sample, make up for all risk of loss and bring the buyer out ahead of investments in high-rated, low-interest bonds."³⁵

Milken noted that trading in junk bonds was occurring in a limited and small-scale way, but he advanced the notion that such trading could be done on a national scale, by creating an orderly, well-managed market. This would enable companies to finance projects by long-term debt capital, provided by investors willing to invest in junk bonds because they would no longer be illiquid. Greater liquidity would have a beneficial effect upon the risk of the bonds, and so on their interest rates.

The question was, how to create a more efficient market for such commercial paper? One of the requirements of efficiency is that buyers and sellers have a substantial amount of knowledge about the "product," difficult to achieve in the junk bond market, where every bond was different in risk and in contract terms. Milken decided that a real market was not possible, but that there could be an "illusory" market. If A buys B's bonds at above market price, A loses. Milken, therefore, had B buy A's bonds at above market price, so that "In the wash, the gains and losses were supposed to roughly tally."³⁶ To avoid being out of balance, A and B sell on the bonds to banks and insurance companies *that they control*. Consequently, it is depositors' and policy-holders' money that is being used, not A's or B's. A and B are content because they gained access, at a price, to long-term debt financing that otherwise would have been unavailable. As Stein notes, "The desire for cash, or the apparent opportunity to make money with that cash, is so great that it simply blocks out many other concerns."³⁷ Milken, of course, benefited as the middleman who essentially controlled both sides of the deal. These were not "arms length" transactions.

Why would this deception not be discovered immediately? Because, says Stein:

"The securities bought usually had no public market, no established

³⁵ Stein, *op.cit.*, p. 35.

³⁶ *Id.* at 68.

³⁷ *Id.* at 70.

prices, and could – by accounting rules, very loosely applied – count as being worth their cost for as long as they were in the portfolio. Even if they in fact defaulted – and this was really beautiful – the issuer could replace them with a handful of new securities to which the buyer could assign any value he wished. Defaults could simply be made to disappear.”³⁸

At this point in his development of an illusory market, Milken still had to develop an answer to the liquidity problem for investors – the vast majority of banks, pension funds and insurance companies that were not under his control. In essence, his plan was to “securitize” the commercial loan business, by turning commercial loans into liquid securities. In addition, Milken promised investors that he would “take them out” of the bonds at a moment’s notice – but not always at a price they would like.³⁹ Milken stated, “High yield bonds are no more than securitized loans, often with fewer [restrictive] covenants.”⁴⁰

Note, however, that the junk bonds were not necessarily worthless. Properly accounted for, as part of a well-managed and diversified portfolio, and with adequate provisions recognized for potential losses, they were, and are, legitimate investments. The existence of securities and markets for securities that are below investment grade but still possess potential value, are valid segments of the overall market for securities. Full disclosure of realistic default rates, several market-makers, not just one, and a more direct connection between borrowers and lenders with less pocketed by the one middleman, might have provided a net benefit to the economy. As it was, many institutions and individuals suffered great losses, and Milken, of course, went to jail.

³⁸ *Id.* at 68.

³⁹ *Id.* at 75.

⁴⁰ Milken, quoted in Stein, *op. cit.*, p. 75.

APPENDIX 6 – DUE DILIGENCE

At the heart of the investment decision making process for angels and venture capitalists is due diligence. Absolutely vital to making a sound investment, due diligence verifies any business opportunities that survive the initial screening stage. Due diligence emphasizes understanding and quantifying the risk of the proposed deal, rather than the upside potential. This due diligence process is intended to be tough on investment proposals. For angels and venture capitalists, as few as 10-15 percent of proposals make it past the initial screening stage to the full due diligence process, and only 10 percent of those receive funding. Indeed, the whole point of this process is to discover potential problems and to eliminate unsuitable proposals from further consideration. This is especially important in a start-up situation, where the venture has no track record or tangible asset base and the market opportunity and competitive advantage of a product or service must be verified.¹

In the most formal of definitions, due diligence is the care that a reasonable person exercises under the circumstances to avoid harm to other persons or their property. In the entrepreneurial venture community, due diligence is the independent investigation of an investment opportunity, and its prospects for success, by a private investor or venture capitalist before funding is provided. It is an intensive and thorough investigation that may take several months to complete and the primary purpose is to understand and minimize the risk to the investor. Due diligence should be started as early in the investment decision making process as feasible. The investor must also make critical decisions between the time to undertake a complete due diligence process and the desire to make the deal under the intense time pressure of the new economy. If the process consumes too much time, the investor may 1) lose the investment opportunity because the entrepreneur may pursue other investors or venture capitalists and/or 2) the critical window of opportunity to get the product to market ahead of the competition may be lost. Thus, time versus thoroughness is a constant conflict throughout the due diligence undertaking. Any methods or systems that can reduce the time to complete due diligence without sacrificing quality will help to increase the efficiency of the external financing process and decrease the time for the commercialization of the innovation.

¹ See M. Van Osnabrugge and R. Robinson, *Angel Investing: Matching Start-up Funds with Start-up Companies. THE GUIDE FOR ENTREPRENEURS, INDIVIDUAL INVESTORS, AND VENTURE CAPITALISTS*, San Francisco, CA. Jossey-Bass, Inc. Publishers, 2000.

For today's entrepreneurs, inventors and venture investors, intellectual property is often the key asset and centerpiece of the critical due diligence process. Unfortunately, this vital role of intellectual property has not translated into initiatives to increase the efficiency of confirming both ownership and prior claims. It may be said with some conviction that intellectual property issues have been very much the "poor cousins" in the due diligence inquiry. Investigators have been assiduous in establishing the existence and value of tangible assets and other intangibles and in confirming the presence or otherwise of encumbrances, but the enquiry into the extent of the intellectual property of the target organization has been left to the often dubious protection of a vendor or licensor warranty, dubious because of the often illiquid status of the provider of the warranty. In the intellectual property context, due diligence involves the investigation to verify and establish the existence of the intellectual property asset and liability and to determine the extent of encumbrances or restrictions on the rights to use the property. This intellectual property due diligence will be of importance to investors in ventures with intellectual property as the core asset and to promoters of the investments (such as the inventor or entrepreneur). In the first case, there will be a concern to verify assurances made by the inventor. In the second case, there will be the necessity of ensuring that statements made in the offering document (usually a private placement) are accurate.²

A. Approaches to Business Valuation

Suppliers of funding require information on the value of what they are being asked to fund. There are several ways of estimating this value. Three methods are commonly used:³

1. Cost: what it would cost today to acquire a similar asset. While this approach is useful in the valuation of tangible assets, it is little used in valuing intangibles.
2. Market comparable: at what price similar assets are currently selling. Again, this approach is useful where there is a developed market, but is little used in valuing intangibles.
3. Projected income: what investors are willing to pay for an asset with a given future income stream. This approach is the most widely used in the valuing of intangibles and especially

² Betts, I., 1997, Legal and Accounting Management Seminars Pty. Ltd., Paper Presented March 24, 1997 at the Due Diligence Seminar: "Intellectual Property Due Diligence".

³ A.M. King and J.M. Henry, *Valuing Intangible Assets through Appraisals*, STRATEGIC FINANCE, November, 1999, pp. 36-37.

intellectual property.

The third approach is essentially an "economic value approach," especially if income is defined as net cash flow rather than accounting net income. The difference between cash flow and accounting net income is principally that accounting net income arises after the deduction of depreciation expense. Depreciation expense is not a cash expense, but spreads, or "expires," the cost of an asset over its expected useful life.

Historically, accounting net income is based upon time-matching revenues with the expenses incurred in earning the revenues, including depreciation. Net cash flow is exactly what it seems, the net of cash movements into and out of a firm. Prior to the reliance of business on costly plant and equipment (tangible fixed assets), the two numbers, net cash flow and accounting net income, were very similar for a given firm in a given year. Production became more and more capital intensive, and more and more cash was spent on plant and equipment that would last for several years. Thus, it became clear that net cash flow was no longer providing a good measure of the operating surplus earned by the firm, and so it was adjusted by the depreciation charge to show accounting net income.

Yet firms grow, survive, or fail based upon their ability to generate cash. No firm has ever succeeded in spending a single cent of accounting net income. Checks cannot be written against accounting net income, but only against cash balances or overdrafts at the bank. In consequence, firms nowadays prepare three related financial statements; a balance sheet, a "snapshot" at a particular time; an income statement, showing the accounting net income over the year to the balance sheet date; and a statement of cash flows, showing cash movements over that same period. Each statement offers a different perspective on the status and condition of the firm. For valuation purposes, however, the net cash flow is the most reliable number, because it is less subject to manipulation than is accounting net income, and has the merit of representing purchasing power in the marketplace. Cash is a matter of fact; accounting net income is a matter of opinion.

1. The Time Value of Money

Money has a time value. The sooner a benefit (cash inflow) is received, the greater its value now. The nearer in time to the present a cash outflow (in broad terms, a cost) is incurred, the larger the impact now. For example, assume that someone is about to be given \$100, and his or her only option, other than spending it now, is to invest it in a money market fund at an annualized yield of 5 per cent, and that this reflects accurately that

person's opportunities, expressed as a "marginal rate of time preference"⁴ of 5 percent. The \$100 will accumulate to \$105 after one year, assuming annual compounding. To that person, the "present value" of \$105 a year from now is \$100, assuming a marginal rate of time preference of 5 per cent. That person regards \$105 in a year's time as being exactly equivalent to \$100 now.⁵ Another person, faced with the same options, but with a higher marginal time preference rate of 8 per cent, would take the \$100 now, because the 5 per cent interest rate would not be sufficient compensation for waiting a year.

The marginal rate of time preference is commonly described as the "discount rate." The discount rate is the reverse of the compound interest rate. Instead of accumulating a present figure to a future figure, it "discounts" a future figure back to a present figure. Effectively, in the example, 5 per cent is the "rate of exchange" between now and the future. This recognition of the value of time has evolved into what are known as "discounted cash flow" methods of appraising business and investment decision data that are expected to stretch well into the future. None of these ideas is new: compound interest was used in the Old Babylonian Period (*circa* 1800-1600 B.C.) in Mesopotamia, and discounted cash flow techniques were applied to business decision-making in the eighteenth century.⁶

Firms similarly use a discount rate, known also as a "hurdle rate," or a "cost of capital." The two principal sources of finance for a firm are debt and equity, although there are hybrids such as convertible securities, and complications such as options and warrants. Debt is usually taken to be long-term debt such as bonds. Interest on debt is a deductible business expense, and the current cost of a bond may be expressed as its current yield. Bondholders have a contractual relationship with the firm that usually requires payment of interest. Equity holders (usually common stock holders) are the residual owners of the firm. They have no rights to regular payments of dividends. Any dividends paid to them are distributions of capital and are

⁴ A rate of time preference measures an individual's attitude towards current versus future consumption of resources. The modifier "marginal" is usually added because the individual's attitude is likely to differ according to whether it is the first or the last \$100 of income.

⁵ This indifference is dependent not upon the existence or otherwise of inflation, but on the use to which the \$100 might be put between now and year from now. Inflation expectations, and other risk factors, will modify the individual's marginal rate of time preference.

⁶ For a detailed discussion of time discounting, see R.H. PARKER, *MANAGEMENT ACCOUNTING: AN HISTORICAL PERSPECTIVE*, Macmillan, London, 1969, pp. 34-58.

not tax-deductible. Bondholders, therefore, are perceived to carry a lower default risk, and so require a lower return. Equity holders carry a higher risk of losing their investment, and so expect a higher return to compensate them for the added risk, commonly in the order of 4 to 6 per cent above gross debt interest. In both cases, the expected return is an opportunity cost rate that offers compensation sufficient to encourage the holders to hold rather than sell their investment.

Most firms calculate their cost of capital based upon these expected returns, weighted by the leverage ratio – the debt to equity ratio at market values. A firm with a cost of debt of 6 per cent after tax, and a cost of equity of 14 per cent, and with a 40 per cent leverage ratio, would have what is called a “weighted average cost of capital” of 12 per cent:

Cost of debt (net of tax):

$$0.06 * 0.40 = 0.024$$

Cost equity:

$$0.16 * 0.60 = \underline{0.084}$$

Weighted Average Cost of Capital: 0.120

The weighted average cost of capital of 12 percent would be the discount rate used by the firm to calculate the present value of a future cash flow stream of firm-average risk.

2. The Economic Valuation of Intangibles

Discounted cash calculations may be performed in a variety of ways, but all (including spreadsheets such as Excel) are based on the formulae given below:⁷

Terminal Value (TV) (compounding): $TV = (1 + r)^n$

Present Value (PV) (discounting of irregular cash flows): $PV = (1 + r)^{-n}$

Present Value (PV) (discounting of annuities): $PV = \frac{1 - (1 + r)^{-n}}{r}$

Present Value (PV) (discounting a perpetuity)⁸ $PV = 1/r$

⁷ Most discounting formulae are constructed on the assumption that the first cash flow will occur in a year from now. The formulae may be changed to recognize an immediate first cash flow, and indeed, to assume continuous rather than discrete (annual or periodic) compounding.

⁸ In a perpetuity, n tends towards infinity and so $(1 + r)^{-n}$ tends towards zero, so that we are, in effect, left with $1/r$. Very long annuities may be approximated closely by assuming a perpetuity.

The present or economic value of the benefit from a patent would be valued by discounting its expected future cash flows by the owner-firm's cost of capital. Thus, if it expected to earn net free cash flow of \$10,000 per year over the next 8 years, and if the firm's cost of capital were expected to be 12 per cent over that period, the present value would be \$49,676.⁹ The powerful effects of discounting may be demonstrated by the fact that the first annual cash flow, to be received in one year from now, has a present value, at 12 per cent, of \$8,929, whereas the eighth and final cash flow has a present value of less than half that amount, \$4,039. This effect of the discounting process has some benefit, in that the later cash flows, which tend to be much more difficult to estimate, have a geometrically shrinking impact on present value.

3. Risk and Value

A cash flow stream of higher or lower than average risk would lead to the weighted average cost of capital being increased by a risk premium or reduced by a risk discount. The term "risk" requires some clarification. Strictly, the terms "risk" and "uncertainty" are not synonyms:

"Uncertainty may be seen as one end of a spectrum, the other end of which is 'certainty.' Certainty may be said to end abruptly, but uncertainty shades into 'risk.' . . . A distinction is often made (only to be disregarded) between risk, where the probabilities of a particular event occurring can be assessed from knowledge and experience, and uncertainty, where the probabilities are not susceptible to such assessment. In practice, a decision problem is likely to contain all three elements, certainty, risk and uncertainty, and so it rarely helpful to distinguish too clearly between the last two."¹⁰

Risk may be associated with general economic conditions, both domestically and globally, or they may be firm-specific, or "project-specific." A firm's average risk is already built into the firm's weighted average cost of capital.¹¹ Some projects, however, have as noted earlier, have

⁹ This was calculated using discount tables, which are readily available in most finance texts.

¹⁰ J. FREEAR, *THE MANAGEMENT OF BUSINESS FINANCE*, Pitman, London, 1980, p.67.

¹¹ Another approach is to use the Capital Asset Pricing Model. This identifies a so-called default risk free rate, being the rate of return on six-month government bonds, and a systematic or market risk based rate being the return on the stock market, which is regarded as an efficient market. As the average investor may remove all firm-specific (alpha) risk by a fairly simple diversification of his stock market portfolio, the only risk for which he requires compensation is the systematic or "beta" risk. This notion, with its linear definition of risk, has lead to the development of an industry based on the

risk characteristics that are not average. The simplest way to deal with such projects is to incorporate an additional risk premium into, or, less commonly, to deduct a risk discount from, the weighted average cost of capital.¹² The impact of an added premium to the weighted average cost of capital is to reduce the present value of the cash flows. For example, using the perpetuity formula given earlier:

$$PV = 1/r$$

And assuming r to be 0.12, the present value of a perpetuity of 1 would be:

$$1/0.12 = 8.33.$$

Adding a risk premium of 4 per cent to 12 per cent to give a discount rate of 16 per cent, the present value of a perpetuity of 1 would be:

$$1/0.16 = 6.25.$$

The present value of the perpetuity is reduced, therefore, by increasing the discount rate to allow for perceived above-average risk.

4. The Economic Nature of Intangible Assets

"Assets represent expected future economic benefits, rights to which have been acquired by the enterprise as a result of some current or past transaction."¹³ Assets are deferred expenses, that is, they are acquired for

calculation of "beta coefficients," which measure the degree of volatility in a stock relative to the market, and enable a judgment to be made as to whether or not the stock is currently valued high, low or about right. A decision to trade might be guided by this judgment. Note, however, that some finance markets may be less efficient, and so the approach just outlined may be less effective in these markets.

¹² The addition of a constant risk premium into the weighted average cost of capital (the discount rate) does not imply that risk is constant over time. Rather, it implies that risk is increasing over time, and at an increasing rate. This is because the same absolute percentage premium is used to reduce the present value of cash flows that are already reduced in present value terms by the basic weighted average cost of capital. Thus the risk premium will have an increasing impact on the present value of later cash flows. Increasing risk may be a reasonable assumption. If, however, it is not, or if the decision-maker wishes to make explicit risk estimates about the expected cash flows in each year, "certainty equivalents" may be used to reduce the value of a risky cash flow to its equivalent cash flow receivable with certainty. The certainty equivalent is rather like a household fire insurance premium. The damage risks associated with a house fire are largely removed by the certain payment of an insurance premium.

¹³ R.T. Sprouse and M. Moonitz, *A Tentative Set of Broad Accounting Principles for Business Enterprises*, ACCOUNTING RESEARCH STUDY NO.3, ACCOUNTING PRINCIPLES BOARD, AICPA, New York, NY, 1962, p. 8.

use, and their value is used up over time in the earning of revenue. The “using up” of assets is recognized by means of “depreciation” charges against revenue. Assets such as property, plant and equipment are “tangible” assets and are depreciated over their expected useful life. Patents, trademarks and copyrights are regarded by the accounting profession as “intangible assets,” and are written off—“amortized”—over a period defined in the body of conventions known as “generally accepted accounting principles.” Following a discussion of plant and equipment assets, Sprouse and Moonitz wrote:

“The . . . discussion of plant and equipment is also applicable to patents, copyrights, research and development costs, goodwill, and the like. In one sense, these items represent assets in their “purest” form because their value depends directly on “future economic benefits” and not indirectly on some physical implement or tool that is capable of providing benefits. Their very “purity” as assets (services) makes them difficult to deal with, however, because current or future exchange prices for them often do not exist. The consequence is that these items are notoriously difficult to evaluate and therefore should probably be carried at acquisition cost in the absence of compelling evidence that their value is markedly different. “Intangibles” of limited term should be amortized as production cost or expense over their estimated service lives. Unlimited items should continue to be carried as assets, without amortization.”¹⁴

APB Opinion No. 17,¹⁵ and FASB Statements No. 2,¹⁶ No. 86,¹⁷ and No. 121,¹⁸ address the accounting treatment of intangible assets, their impairment, and related issues. Generally, intangible assets are recorded in the books of account at cost, including costs of acquisition, and costs needed to make the assets ready for its intended use, such as legal fees. If intangibles are acquired for stock or in exchange for other assets, the cost of

¹⁴ *Idem*, p. 36.

¹⁵ “Intangible Assets,” Opinions of the Accounting Principles Board No. 17, New York, American Institute of Certified Public Accountants, 1970. See Appendix 1, Page 18 for a summary.

¹⁶ “Accounting for Research and Development Costs,” Statement of Financial Accounting Standards No. 2, Stamford, Conn, Financial Accounting Standards Board, 1974. See Appendix 2, Page 19 for a summary.

¹⁷ “Accounting for the Cost of Computer Software to be Sold, Leased, or Otherwise Marketed,” Statement of Financial Accounting Standards No. 86, Stamford, Conn, Financial Accounting Standards Board, 1985. See Appendix 3, Page 20 for a summary.

¹⁸ “Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of,” Statement of Financial Accounting Standards No. 121, Stamford, Conn, Financial Accounting Standards Board, 1995. See Appendix 4, Page 21 for a summary.

the intangible is the fair market value of the consideration given, or the fair market value of the intangible received, whichever is more clearly evident. Any costs incurred within the company, however, are expensed as they are incurred, unless they can be directly identified, such as the legal costs of applying for a patent. Internal research and development costs, for example, are generally expenses as incurred, rather than being capitalized and amortized. An intangible asset becomes "impaired" whenever the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset.¹⁹

a) Patents

A patent may be regarded as an agreement between an inventor and the federal government. Under that agreement, the inventor obtains the exclusive right (for a limited time) to make, use, and sell his invention, in return for making the invention public by giving the government certain information about it.²⁰ Generally accepted accounting principles perceive a patent to be an exclusive right recognized by law and registered with the U.S. Patent and Trademark Office. The life of the patent is twenty years from the first filing, but the amortization should occur over the estimated useful life of the patent, or the legal life of twenty years, whichever is shorter. "Estimated useful life," means the period during which benefits are received. If, during that period, legal a company incurs legal fees in successfully defending the patent, then those fees may be added to the asset account and will then be amortized. If patent owners contract to allow another party to use the patent for a stated time period in return for royalties, the patent owner continues to amortize the patent and recognize the royalties earned as revenue.

b) Trademarks

The term "trademark" connotes names, symbols, or other distinctive identities given to companies, products, and services, and registered with the U.S. Patent and Trademark Office. There are four kinds of marks: trademarks, service marks, certification marks, and collective marks. Registered trademarks may be renewed indefinitely for successive twenty-year periods. Generally accepted accounting principles require that the cash equivalent amount paid for the trademark be capitalized, along with any

¹⁹ *Idem.* See the earlier discussion of time discounting.

²⁰ See J.P. MALLOR, A.J. BARNES, T. BOWERS, M.J. PHILLIPS, AND A.W. LANGVARDT, *BUSINESS LAW AND THE REGULATORY ENVIRONMENT*, New York, Irwin/McGraw-Hill, 1998, pp.144-152.

costs directly incurred in the development, protection, expansion, registration or defense of a trademark. These costs must be amortized over the useful life of the trademark, or forty years, whichever is the shorter.

c) Copyrights

Copyrights represent a protection given by law to, for example, authors of literary, musical, artistic, or other works. Copyright law protects a copyright for the life of the author plus fifty years. Generally accepted accounting principles require that the cost should be amortized over the period it is expected to produce revenue, but in no case should a copyright be amortized over a period in excess of its remaining legal life, or forty years, whichever is shorter.

5. The Accounting Valuation of Intangibles

The above discussion of the accounting treatment of intangibles is essentially transaction-cost based. The accounting valuation of intangibles bears little relationship to the value of their expected future benefits to the firm. As in other areas of financial reporting, the accounting profession tends towards the objective historic transaction cost that is largely irrelevant for valuation purposes, rather than a relevant (value of expected future benefits) but subjective valuation. There are notable exceptions, however, such as oil and gas reporting, and future pension obligations. The accounting profession prefers conservative numbers and it prefers not to estimate or certify value.

Accountants are more comfortable with an objective “hard” number, historical cost, that may be determined by the examination of documents supporting the transaction that gave rise to the cost. Any number of accountants, in assessing the same evidence, will tend, independently, to come up with the same cost number. If an intangible were acquired by an arm’s length transaction, it would appear in the balance sheet at this objectively determined cost, and would then be amortized (see above). If the intangible asset were acquired by means other than an arm’s length transaction, for example, as the product of the firm’s own research and development efforts, it would not be treated as an asset, but would be expensed as incurred.²¹ In the firm’s financial statements no attempt is made to measure the value of the future benefits expected to be derived from ownership of the intangible asset.

²¹ Except, for example, and as noted earlier, for legal and other fees in establishing or defending a patent.

In a recent article, A.M. King and J.M. Henry argued strongly that generally accepted accounting principles are out of date in their treatment of intangibles.²² The article noted that the accounting profession strives, among other objectives, to produce financial statements that are both relevant and reliable. Reliability is achieved by the historic cost approach based on transactions, but at the expense of relevance. King and Henry asked: "How can a company, such as an Internet or high-tech company provide this relevant information if it can't discuss its intangible assets? For almost any Internet or high-tech company, Property, Plant and Equipment ("PP&E") is far less important than the idea, the software, the workforce, or the distribution channel. These firms invariably also have little or no inventory. In short, accounting doesn't capture the essence of these firms. Their real assets – the ones current and prospective shareholders are interested in –aren't captured by GAAP."²³

King and Henry observed that the reliability issues may be resolved through the professional appraisal of intangible assets. Major banks, they stated, are willing now to lend on intangibles, although they may require annual valuations. These valuations would be performed by professional appraisers, who follow the "Uniform Standards of Professional Appraisal Practice." These standards require the use of one or more of three appraisal bases: cost, market comparable, and projected income. They noted that: "The banks tended to lend the borrowers approximately 30% of the valuation of the intangible assets. By filing appropriate legal documents, the banks were able to obtain a perfected security interest in these intangible assets."²⁴

King and Henry concluded: "If the valuations appraisers perform are reliable enough for banks to lend against, then the values are equally reliable for disclosure in financial statements. Companies should be permitted – perhaps even required – to disclose the values of their major intangible assets . . . This information can appear in footnotes or in the Management Discussion and Analysis ("MD&A"), which are reviewed by auditors."²⁵

A well-respected intermediate accounting textbook delivers a similar message:

"In this emerging economy of knowledge, even some banks have concluded that 'soft' assets (like computer programming know-how and information infrastructure) can be a better credit risk than 'hard' assets (like

²² A.M. King and J.M. Henry, *op. cit.*, pp.33-37.

²³ *Idem*, p. 35. GAAP stands for "generally accepted accounting principles."

²⁴ *Idem*, p. 35.

²⁵ *Idem*, p. 36

buildings). But how should the 'soft' assets be valued? Accountants get little solace from former FASB chairman Donald Kirk, who acknowledges, 'There are arguments that balance sheets ignore certain intangibles, but the reporting issues of trying to recognize them are, in my mind, insurmountable.' It appears that the assets that really count are the ones accountants can't count – yet.²⁶

A clue as to the latest thinking of the accounting profession is to be found in the Exposure Draft issued by the Financial Accounting Standards Board ("FASB") in September, 1999. The Exposure Draft is entitled, "Business Combinations and Intangible Assets, and part of its summary deals generally with intangible assets: "The current 40-year maximum amortization period for acquired intangible assets (other than goodwill) would be replaced with a presumption that their useful lives are 20 years or less. However, amortization of intangible assets over lives that are longer than 20 years and nonamortization of assets with indefinite lives would be permitted if certain criteria are met. The Exposure Draft would not change the current requirement to write off the cost of purchased research and development assets at date of acquisition."²⁷

The FASB web site answers a series of "frequently asked questions," including the following, which deals with the expensing of "in process" research and development costs that have been purchased as part of an acquisition:²⁸

"Q3. Would the Exposure Draft change the accounting for purchased in-process research and development assets (that is, the current practice of writing off the cost of those assets at date of acquisition)?"

No. The Exposure Draft would *not* change the current practice of writing off the cost of purchased in-process research and development ("IPR&D") assets at date of acquisition. Following recent research and deliberations on this issue—which included discussions with constituents—the Board concluded that the accounting for purchased IPR&D assets should not be considered separately from the accounting for other

²⁶ D.E.KIESO AND J.J. WEYGANDT, *INTERMEDIATE ACCOUNTING*, Wiley, New York, 9th edition, 1998, p.593. The quotation by Donald Kirk is from his article, "Searching for Nonfiction in Financial Statements," *Fortune*, December 23, 1996, p. 38. It might well be argued, however, that while accountants are capable of validating a professional appraisal of intangibles, they have, so far, chosen not to do so. FASB stands for "Financial Accounting Standards Board."

²⁷ September 1999 FASB Exposure Draft, "Business Combinations and Intangible Assets," Financial Accounting Standards Board Website p. 1.

²⁸ *Idem*, pp. 3-4.

research and development costs. The FASB may decide to undertake a separate project at some future date that would reconsider the accounting for research and development in its entirety.”²⁹

The FASB seems, therefore, to be holding to the expensing of research and development costs. Aside from a change in the normal maximum period over which the amortization of intangible assets may occur, and an increased disclosure requirement, there seems to be no evidence that the FASB is contemplating any radical shift from the existing cost-based valuation approach.³⁰

“Q30. How would the Exposure Draft change the accounting for purchased intangible assets other than goodwill?”

APB Opinion No. 17, *Intangible Assets*, currently limits the amortization period for intangible assets to a maximum of 40 years. The Exposure Draft would eliminate that 40-year maximum and replace it with a presumption that the useful life of an intangible asset is 20 years or less. However, intangible assets with useful lives longer than 20 years would be amortized over those longer lives if certain other criteria are met.

The Board also believes that some intangible assets have useful economic lives that are indefinite and therefore amortization of those assets is inappropriate. The Exposure Draft would permit nonamortization of intangible assets with indefinite lives if they meet certain criteria. Those intangible assets would be reviewed for impairment annually.

The Exposure Draft also would require disclosure of information about each significant class of intangible assets acquired, such as their fair value at date of acquisition, the method of determining that fair value, and their weighted average useful life. Annual financial statements would include disclosure of the gross carrying amount, accumulated amortization and amortization expense for each class of intangible asset, as well as the amount and description of any intangible asset not being amortized.

B. Initiatives to Develop a Marketplace for Intangibles

In the valuation of an entrepreneurial venture, investors consider three interrelated components: intellectual property, the management team and the potential market. Clearly, without the intellectual property, as

²⁹ The accounting for purchased research and development assets acquired in a business combination is addressed by FASB Interpretation No. 4, “Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method.”

³⁰ *Op. cit.*, pp.17-18.

exhibited in a patent, there is not a market nor is there a need for a management team to commercialize the intellectual property. Thus, valuation begins with the intellectual property and is interwoven throughout the process.

The valuation of patents, one of the essential ingredients, is central to the valuation of the entrepreneurial venture. In an attempt to place a value on patents and to increase the efficiency of their commercialization, several initiatives to develop a patent marketplace are currently under consideration. Many of these initiatives include fledgling online auction based markets for patents as indicated by the growing number of private online auctions and exchanges for patents popping up around the country—each hoping to use the reach of the Internet to connect universities, corporations and individual inventors with elusive buyers.³¹

Executives at these *online* start-ups say they intend to do for patent rights and other forms of intellectual property what Christie's and Sotheby's do for antiques or what Nasdaq or the New York Stock Exchange do for stocks—develop secure markets where buyers can be confident of what they are purchasing and sellers know they will get a competitive price. These online companies hope that the current rage for e-commerce will carry over to intangible property—creating a booming market in inventions, trademarks and copyrights.

While there are skeptics, several experts in both licensing of patents and online trading believe there's an opportunity for at least a few of these patent exchanges to succeed.³² Examples of these sites include Patent & License Exchange (Pl-x.com), Yet2.com, PatentAuction.com, Virtual Component Exchange and Intellectual Property Technology Exchange (<http://www.techex.com>). Each of these companies has a slightly different approach, but what they all agree on is that large numbers of patents awarded to individuals, companies and research centers—160,000 U.S. patents this year alone—are worthless unless they can find their way to businesses willing to shepherd them to market. The key to these online patent marketplace companies is to make transactions easier and more efficient, whether as auctions or something akin to a computerized dating service that helps buyers and sellers find one another.³³

As an example of trends to arrive at marketplace valuations of patents, the Patent and License Exchange offers a secure, anonymous, neutral

³¹ P. Jacobs, *Marketplace of ideas selling patents online*, LOS ANGELES TIMES, Monday, October 25, 1999.

³² Id.

³³ Id.

forum to buy, sell, license or resell the rights to patents around the world. Pl-x.com aims to aggregate buyers and sellers around the globe into a searchable database and to offer tools to process transactions cut down on risk through providing patent validity insurance, escrow services and a suggested pricing system. These services are intended to transform intellectual property into a liquid asset.³⁴

In an effort to more accurately place value on intellectual property, the value of the firm in ownership of, or commercializing, the intellectual property often serves as a proxy to the value of the underlying intellectual property. In effect, IP valuation has shifted to venture valuation, also a difficult exercise in today's entrepreneurial economy. In this valuation small companies are preferred over larger ones because, ironically, enterprise value is a more accurate proxy for technology value in small, early-stage companies—particularly those ventures that have not yet launched their main product and have no revenue. Unlike the large mature company, the enterprise value of a small, revenue-less company is not affected by perceived earnings momentum (it has no sales), nor management reputation (its management is typically new and relatively unknown). Free of these impurities, the enterprise value of a small "pure-play" company is left as a relatively pure measurement of the value the market is assigning to the company's technology—its intellectual property.³⁵ Thus, enterprise value (the value placed on the venture) is a closer proxy to intellectual property value when the existence of externalities to the core business are at a minimum. A larger, mature enterprise derives value from a variety of sources and in such a case it is difficult to "trace" value back to the underlying intellectual property or to disaggregate valuation to the proportion derived directly from intellectual property.

In an attempt to gauge and track the market value of intellectual property the enterprise value has been used. Since a company's market cap is driven by the value of both its tangible and its intangible assets, market cap indices do not and cannot reasonably claim to represent value creation in intangible assets. To do so they would have to have subtracted from them the value of their component companies' tangible assets—their book values. In other words, the indices should be based on market caps minus book values, a metric commonly known as enterprise value. Enterprise value is a fairly common valuation yardstick used in securities analysis to approximate the value of a company's technology.³⁶

³⁴ S. Kalin, *Patents for Sale*, HOT TOPICS E-COMMERCE, 1999.

³⁵ A.K. Arrow, An index for our era, pl-x.com website, 1999.

³⁶ *Id.*

A new index, the Intangible Asset Market ("IAM") Index has been proposed by The Patent and License Exchange, Inc. The index is intended to fulfill three roles: as a benchmark of raw technology value in various sectors, to provide for quantitative risk measurement of unique IP assets, and to act as a leading indicator for shifts in stock prices of large, technology-rich companies. As noted by the Patent and License Exchange, Inc.: The 150 companies whose enterprise values make up the five IAM Indices qualified to become components according to a highly specific but non-traditional set of criteria. The companies are: technology-rich, non-service businesses heavily dependent on intellectual property; highly focused ("pure-play") companies in a particular technology niche; minimal revenues and/or earnings; early stage, smaller companies, with minimal infrastructure and globally diverse.

C. *Security Interests in Intangibles*

As stated previously, the early stage equity transaction includes finding the investor (or the investment), initial screening, evaluating the investment opportunity and conducting due diligence, negotiating the deal and pricing and structuring deals. After conclusion of the transaction, monitoring the investment and harvesting the venture are essential undertakings. The consideration of intellectual property is critical in the due diligence and valuation stage. Increasing the efficiency, in terms of both time and money, in the due diligence phase would assist both entrepreneurs/inventors and investors. Perfecting a lien on a patent is an integral component of due diligence, and any decrease in the time to perfect the lien while result in a streamlining of the transaction process.

In the lightning speed of the new economy, where opportunities and market niche can be lost in a short period of time, any increase in the efficiency of the process will naturally allow innovations to decrease their time to market and contribute to the chance of the survival of the commercial venture. In this process of increasing efficiency and decreasing the time to accomplish technology transfer, opinions vary on both the need and the benefactor of this reduction:

"Some patent experts are lukewarm on the idea of Internet based patent transactions, however. Lita Nelson, director of the Massachusetts Institute of Technology's technology licensing office, says *an auction based Internet* model won't work well for university patents, which deal with very early stage technology. There is no substitute for assessing technology by meeting its developers and evaluating how it could be used, she adds. Others agree. "It takes time and energy to understand the value of a patent," says Kevin DeBre, a partner in the technology group of Brobeck, Phleger &

Harrison LLP in Irvine, CA. On the commercial side, companies are hesitant. "It is a good idea, [but] I don't know if it is a viable idea," says Brad Friedman, senior vice president and patent counsel at Varian Medical Systems Inc., Palo Alto, a maker of medical devices and software for oncology. Such an exchange would appeal more to start-ups that need to make money quickly on their intellectual property than to larger companies, like Varian, which already has technology-transfer mechanisms in place, he notes."

The patent process can best be surmised through an examination of the typically commercialization process for intellectual property. Using the electronics industry as an example:

"The problem is particularly acute in the electronics industry. About a quarter of the 600,000 patents available for trade each year worldwide concern electronics. And, patents in the electronics field become obsolete faster than those in any other area. Particularly in the fast-paced computer, consumer, and communications segments of the electronics market, the technology landscape can change in anywhere from six to 18 months.

The existing, inefficient way of trading in patents requires several steps. If you want to sell a patent, you'll often spend a year trying to find somebody who wants to buy it. Similarly, buyers who are looking for a new design or technology patent will spend a year trying to find the right one.

Next, you have to decide what the patent is worth. That takes six months if you're lucky, and two or three years if you're not. The problem is that a patent is essentially a right to use a technology. But what's the value of that right? If you're selling patented core circuitry that can be turned into the best communications chip around, you'll set a pretty high price. But a potential buyer must assume a number of risks: risk of the patent's validity, development risks, fabrication risks, and even the risk that someone will infringe on the patent. The buyer naturally wants all of this factored into the equation. Thus, the patent's price becomes the all-important indicator of the potential reward versus all that risk. And once the parties settle on a price, they could take another six months to close the deal."³⁷

The table below summarizes some of the time and cost points for the commercialization of a patent.

³⁷ J. Child, *Technology Breakthrough*, ELECTRONIC DESIGN, pl-x.com website, 1999.

Process	Time	Cost
Need for financing or buyer	Up to 1 year	Equity share negotiated
Negotiating the Deal and -		
establishing patent value	6 months to 3 years	Up to _ the patent value
Searching lien Databases	varies	Up to \$500 per state

To assist in assigning values to patents in the absence of an auction market to establish values, an adoption of the Black-Scholes option pricing model has been proposed. In the context of options, real options theory is combined with data from publicly traded technology-rich companies to compute reasonable market values for patents. In the context of the Black-Scholes option pricing model: A patent, like a call option, is a right to an asset which may or may not have future value. Patents are typically offered for sale or license in units of related patents covering a single product line, and they are valued based on their financial risk and reward... Patents, and unit combinations thereof, are real options. The Black Scholes option pricing formula, with the precise, transparent, reproducible price it calculates for traded equity options led to the robust, liquid options marketplace we enjoy today...the suggested patent values give the buyer and seller a starting point for auctions or negotiations. Because some of its inputs are the market prices of publicly traded stocks, the price changes daily.

D. Insurance for Patent Validity

Historically, market gaps or discontinuities represent an opportunity niche for business. In the case of patent transactions, the need for a recording system for security interests in intellectual property represents such a discontinuity that has fostered the emergence of patent validity insurance. The insurance, intended to achieve some reduction of the risk associated with the acquisition of a patent, adds to the transaction cost and the cost of commercialization technology. This additional transaction cost in turn adds to the cost of the early stage equity investment, in terms of both the amount of external capital required and the increase in the equity share that an entrepreneur must relinquish. The cost of patent validity insurance can serve as a proxy to the benefit of a recording system for security interests in intellectual property which would in part eliminate the need for certain provisions in the insurance. The leader in the field, Swiss Re New Markets, a division of the Swiss Reinsurance Company, has developed a new patent

validity insurance available with the purchase of patents and licenses. As with title insurance for homebuyers, the insurance provides protection against liens and ownership other than the seller. In terms of the scale of the market for the Swiss Reinsurance Company product:

For most companies, intellectual property ("IP") today is the most important corporate asset. But this most important asset and the associated risks are almost completely uninsured. The corporate IP insurance market is an emerging, new market with large potential benefit to companies whose strength lies in innovation.

IP has increased dramatically in importance for corporations over the last 20 years. In 1982, the hard assets of industrial companies were said to account for 62% of the companies market value. By 1992, tangibles made up 38% - and intangibles 62% - of their value. In 2000, intangible assets and IP values are clearly the most important asset of most industrial companies. Driving factors behind this increase are:

- A increased intensity of competition,
- A increased rapidity of technological growth and innovation,
- A increased reliance on legal protection of rights in IP and increased enforcement of IP rights,
- A increasingly sharp liability standards for infringement and misappropriation.

The annual number of patent infringement losses exceeding US \$10 million doubled since 1993, and losses of US \$100 million and more are no longer uncommon today. Exposed companies include those in the electronics, pharmaceuticals, machinery, computer, bio-technology, medical devices and equipment, automotive, chemicals, textiles, telecommunications, toys, sporting goods, and building materials industries.³⁸

The concept behind the patent validity insurance is to protect the buyer and to provide the seller with a more accessible market since the insurance affords a degree of downside risk protection for the investor. A patent validity coverage indemnifies the patent buyer or licensee for amounts lost due to a later invalidation of the patent. Each ... buyer or licensee is protected against the risk of financial loss that can arise when the purchased

³⁸ See Swiss, Re, *The significance of intellectual property assets, risks and insurance*, SWISS RE WEBSITE, 2000.

patent is declared invalid. Invalidity could be declared, for example, if the inventor or patent applicant failed to disclose information in the patent application process or because of outright fraud, such as a fictitious patent or a patent offered for sale by someone other than its owner. Coverage can be provided for the buyers purchase price or license fees, plus tooling costs and even for investment in developing the new product from the patent rights acquired.

The insurance may also enhance market liquidity since the investor or licensee can be insured for the amount of the up-front purchase price paid for the license or patent. According to William Hoffman, associate director of Integrated Risk Solutions: "Patent validity insurance is a win-win product. It promotes the growth of a new market by reducing risk. Sellers as well as buyers benefit from this coverage. Businesses with marketable intellectual property seeking to deploy their valuable but non-performing intangible assets benefit from the increased number of buyers who are willing, ready, and able."

Specific insurance coverage for the buyer or seller varies. Some features of the insurance protection include:

- A indemnity for damages for which the insured is liable to third parties,
- A legal costs incurred in defending a patent infringement claim,
- A legal costs incurred in defending an injunction claim,
- A legal costs in bringing an action for a declaration of non-infringement,
- A discretionary coverage for a single lump-sum paid-up license royalty, and
- A flexibility for providing specialty coverage for other client-specific IP risks.³⁹

The valuation of intellectual property is central to the valuation of the entrepreneurial venture.

³⁹ See SWISS RE WEBSITE, 2000.

APPENDIX 7 - EXCLUSIVE AND NON EXCLUSIVE LICENSES

Both the exclusive and nonexclusive licenses seem to be forms of personal property within the broad scope of U.C.C. sections 9-102 and 9-106.¹ When the debtor is the licensee, not the licensor, the licensor is the "account debtor." A licensor/account debtor is the person *obligated*, but the obligation is a performance obligation rather than a monetary obligation. The licensor "owes" the licensee/debtor forbearance from suit, as long as the debtor abides by the terms of the license. It is this contractual forbearance, which permits the licensee a limited use and gives value to the license as "intellectual property" while in the hands of the licensee.² However, the

¹ U.C.C. § 9-102(1)(a) and § 9-106, cmt. ¶1. Revised Article Nine defers to "other law" on the issue of whether a particular debtor/licensee acquires "property" under a license of intellectual property. U.C.C. [Revised] § 9-408, cmt. 3. Cases involving private licenses are rare. *In re Stirling Gold*, Bankruptcy No. 77-B-1209 (Bankr. S.D.N.Y. 1980); (A license to distribute a film is a general intangible); Section 541(a)(1) of the Code does not make transferability a predicate to the definition of property which passes to the estate when the petition is filed. 11 U.S.C. § 541(a)(1). See *In re Ryerson*, 739 F.2d 1424, 1425 (9th Cir. 1984) ("...[T]he requirement that the debtor must be able to transfer the interest...has been eliminated under the Code.") Governmental licenses such as liquor licenses and water permits are often found to be general intangibles despite the control that the licensor can exercise over transfer. *Bogus v. American National Bank of Cheyenne*, 401 F.2d 458, 5 U.C.C. 937 (10th Cir. 1968); *In re Dalcon*, 120 B.R. 620, 13 U.C.C.2d 524 (Bankr. D. Ma. 1990); *Lake Region Credit Union v. Crystal Clear Water*, 502 N.W.2d 524, 21 U.C.C.2d 775 (N.D. 1993); *Rushmore State Bank v. Kurylas, Inc.*, 424 N.W.2d 649, 6 U.C.C.2d 863 (S.D. 1988); *Queen of the North, Inc. v. Legrue*, 582 P.2d 144, 24 UCC 1301 (Ala. 1978). The result may be different if the state has specifically excluded such a license from the definition of "personal property." *In re Sheldon*, 1988 Lexis 1420 (Bankr. N.D. Ind. 1988). For a broad definition of "personal property" under U.C.C. section 9-102 see *Travis v. Trust Company Bank*, 621 F.2d 148, 150 (5th Cir. 1980). Priority between a secured lender and a nonexclusive license is not clearly covered under the priority rule in section 9-301(1)(d).

² The definition of an account debtor in U.C.C. § 9-105(1)(a) refers to "the person who is obligated on an account, chattel paper or general intangible." U.C.C. § 9-105(1)(a). Accord U.C.C. [Revised] § 9-102(a)(3). This language must be aimed at the person whose obligation gives the account, chattel paper or general intangible its value. Under the present language of Article 9, when intellectual property is licensed, both the licensor and the licensee are left with personal property in the form of a general intangible. The licensor owns an income stream and other contract rights on which the licensee is the "account debtor." If this income stream is not an account, chattel paper or instrument, it must be a general intangible. The licensee owns a right to use, and, in varying degrees, a right to insist on the licensor's forbearance. The licensor, therefore, should be viewed as the "account debtor" whenever the debtor is the licensee, because it is the licensor's obligation which gives the license its value in the hands of the debtor. The definition of "account debtor" could be read expansively, however, to cover *any person*, including the debtor obligated on a general intangible. In that case, a "debtor" using a license or permit

problem with unrestricted recognition of a debtor's licenses as collateral is found in the debtor's reciprocal obligations to the licensor/account debtor. Typically, the debtor is not able to transfer the license without the licensor/account debtor's consent. The debtor may have to use the license in a manner regulated by specific standards. For example, a franchisor of a retail chain or the governmental issuer of a broadcast license may want to control quality and, to that end, circumscribe certain actions of the actual owner of the store or the operator of the radio station. In order to assure that the licensor's control cannot be frustrated by a third party, the licensor may want to construe *any* attempted transfer, including one for security, as a breach of the license and grounds for termination.

The current Article Nine language in section 9-318(4) invalidates any contract term that "prohibit[s] assignment of an account or prohibits creation of a security interest in *a general intangible for money due or to become due* or requires the account debtor's assent to *such assignment or security interest*."³ This language invalidates transfer restrictions, such as the prohibition in the franchise agreement set forth above. However, when the general intangible used as collateral is the income stream from the intellectual property, for example the franchise fees, Article Nine is silent on the validity of restrictions which benefit the licensor/account debtor when the licensee is the debtor and the collateral is the license itself. By negative inference from current section 9-318(4) such restrictions are effective. Therefore, the licensor can make the creation of a security interest in the license a breach of the agreement and thus grounds for terminating the license. Arguably, the licensor should not be able to frustrate the licensee debtor's legitimate interest in using a valuable license as collateral. Permitting the licensee to create a security interest in the license does not, until default, undermine the licensor's interest in deciding who should be able to exercise the rights granted under the license. It is only the secured party's unrestricted right to retain or dispose of the license *on default*, which undermines the licensor's legitimate right to control the licensee's identity.

In 1992, the Article Nine Study Committee recommended that:

"The Drafting Committee . . . give serious consideration to whether Article 9 should be revised to provide that a prohibition on the assignment of a private or governmental contract, license, or permit is ineffective to prevent the attachment or perfection of a security interest, and the creation of a

as collateral could also be viewed as an "account debtor" in the same transaction because of the contractual or other restraints (e.g. assignment prohibited) which the licensee debtor owes to the third party licensor. See U.C.C. [Revised] § 9-408, cmt. 5. See also PEB Study Group Uniform Commercial Code Article, *Report 178* (December 1, 1992).

³ U.C.C. § 9-318(4).

security interest in the debtor's rights under the contract, license, or permit does not give rise to a default under the contract, license, or permit notwithstanding any agreement or other law to the contrary."⁴ Section 9-408(a) of Revised Article Nine was drafted in response to the Study Committee's recommendation. The subsection renders "ineffective" anti-assignment and anti-collateral transfer language in a general intangible to the extent that such language "prohibits, restricts, or requires the consent of the... account debtor to the . . . creation . . . of a security interest."⁵ The rule does not, however, make anti-assignment language ineffective to thwart assignments. Only when the language is used to prohibit transfers of security interests does the prohibition render the language ineffective. Nevertheless, to the extent that such restrictive language is "effective under other law," the security interest is (1) not enforceable against the account debtor, (2) imposes no duties on the account debtor, and (3) can be ignored by the account debtor.⁶

The Revision language does not really break from prior law on this point. The rule in Revised Article Nine generally follows an approach taken by some courts under current Article Nine. These courts have held that a security interest can be granted in a nontransferable governmental license, but "limited to the extent of the licensee's proprietary rights in the license vis a vis private third parties."⁷ Thus, the secured party cannot realize on the security interest in the license unless the necessary foreclosure-related disposition has the approval of the licensor. Perhaps it also means that the secured party can assert no rights in the license property until an approved transfer of the property occurs. A typical security agreement prohibits the

⁴ PEB Study Group Uniform Commercial Code Article, *Report* 178 (December 1, 1992).

⁵ U.C.C. [Revised] § 9-408(a). On default, Revised Article Nine section 9-607(a)(1) provides the secured party with a broadly defined right to "collect" an account debtor's "obligation." U.C.C. [Revised] § 9-607(a)(1). That post-default right to insist on an account debtor's contractual performance should yield to the limitations on any disposition of the debtor's license without licensor consent in Revised section 9-408(a).

⁶ U.C.C. [Revised] § 9-408(d). See *In re CFLC, Inc.*, 89 F.3d 673 (9th Cir. 1996) ("A patent license is nonassignable as a matter of 'federal common law.'").

⁷ *In re Ridgely Communications, Inc.*, 139 B.R. 374, 379 (Bankr. D. Md. 1992); *In re Thomas Communications, Inc.*, 161 B.R. 621, 625-26 (Bankr. S.D. W.Va. 1993). There is considerable authority for the proposition that a patent license is a personal right not assignable absent the licensee's consent under the "applicable law" (i.e. the federal common law of patents) in section 365(c) of the Bankruptcy Code. *In re CFLC, Inc.*, 89 F.3d 673, 679 (9th Cir. 1996); *In re Alltech Plastics, Inc.*, 71 B.R. 686, 688-90 (W.D. Tenn. 1987); *In re Patient Education Media, Inc.*, 1997 LEXIS 953 (Bankr. S.D.N.Y. June 30, 1997). However, a bankruptcy court has permitted the assignment of a trademark license, finding that "applicable law" was a narrow reference to personal service contracts. *In re Rooster, Inc.*, 100 B.R. 228, 232-34 (Bankr. E.D. Pa. 1989).

unauthorized sale of the debtor's collateral. While such an unauthorized transfer by the debtor could be made an event of default, it is not clear that a secured party could enforce such a clause against a debtor who sought to transfer the license with the licensor's approval. All that may be left to a secured party with a security interest in the debtor's license is the right to the "proceeds" of a sale that is approved by the licensor.⁸ When the account debtor/licensor terminates the debtor's license pursuant to terms other than those that are rendered "ineffective" by Revised section 9-408(a) and (c), the secured party does not appear to have a basis for objection. This conclusion seems to hold even when such a termination would be wrongful against the debtor.⁹

The Official Comment to Revised section 9-408 creates a curious limiting annotation on the statutory rule. The "ineffectiveness" language in Revised section 9-408(a) reaches those license terms that prohibit, restrict or require the consent of the licensor. The concept of a term that "restricts" the debtor/licensee's ability to create a security interest has been given a narrow (perhaps overly narrow) spin by the drafters of the Revisions in Official Comment 6. According to this Comment, a covenant in a license that merely "impairs" the licensee's ability to create a security interest is not rendered ineffective. Furthermore, a non-disclosure covenant only "impairs" the licensee who seeks to use the license as collateral—it does not "restrict."¹⁰ Apparently, terms in the license that prohibit disclosure can be invoked by the licensor to prevent the licensee from furnishing a potential secured party with information about the intellectual property underlying the license. As a practical matter, this information is often critical to any valuation of the license as collateral, and thus critical to the creditor's decision to go forward with the requested secured loan.

⁸ *In re Thomas Communications, Inc.*, 161 B.R. 621, 625-26 (Bankr. S.D. W.Va. 1993).

⁹ *See Capital Nat. Bank of New York v. McDonald's Corp.*, 625 F. Supp. 874, 42 UCC 1048 (S.D.N.Y. 1986).

¹⁰ U.C.C. [Revised] § 9-408(d), cmt. 6.

APPENDIX 8 - SOFTWARE

The most troublesome categorical problem under the present language of Article Nine arises when the secured party is financing the supplier/licensor of software. To the extent that the sale of a software package to a user or other consumer makes the *medium* of the software predominant, it is likely to be considered a sale of goods.¹ If the software provided does not involve hardware and appears to be custom-made for the licensee, involving the licensor directly in the licensee's needs and business patterns, the software license may be viewed as a "service" contract.² Under either of these scenarios, the resulting income stream produces a section 9-106 "account" not a "general intangible." Otherwise, the income streams from other more passively transmitted and typical forms of intellectual property are "general intangibles" under current language because they do not fit within either the "goods" or "services," predicate for an "account." Typically, but not always, these sale or licensing income streams also fall outside the Article Nine documentary categories of "instruments,"³ and

¹ Computer Servicenters, Inc. v. Beacon Mfg. Co., 328 F. Supp. 653, *aff'd*, 443 F.2d 906 (4th Cir. 1971); Systems Design & Management Information, Inc. v. Kansas City Post Office Employees Credit Union, 14 Kan. App.2d 266, 788 P.2d 878, 11 UCC2d 775 (1990); Wharton Management Group v. Sigma Consultants, Inc., 1990. LEXIS 54 (Del. Super 1990), *aff'd* 582 A.2d 936 (Del. 1990); Geotech Energy Corp. v. Gulf States Telecommunications & Information Systems, Inc., 788 S.W.2d 386 (Tex. App. 1990); Micro-Managers, Inc. v. Gregory, 147 Wis.2d 500, 434 N.W.2d 97 (Ct. App. 1988); Data Processing Services, Inc. v. L.H. Smith Oil Corp., 492 N.E.2d 1329, 1 UCC 29 (Ind. App. 1986). The sale of goods classification predominates and is used even when the software is custom tailored. See, e.g., Advent Sys., Ltd. v. Unisys Corp., 925 F.2d 670 (3d Cir. 1991). Revised Article Nine explicitly defines "software" and places it within the broader category of "general intangibles." U.C.C. [Revised] § 9-102(a)(42)&(75).

² Conopco, Inc. v. McCreddie, 826 F. Supp. 855, 870-71 (D.N.J. 1993). See also Rodau, *Computer Software: Does Article 2 of the Uniform Commercial Code Apply?*, 35 EMORY L.J. 853, 864-74 (1986).

³ These income streams are generally not "instruments." Rights to payment that arise out of assignments or licenses of intellectual property might be, but are not typically, captured in negotiable instruments or in other documents "of a type" which are "in ordinary course of business ... transferred by delivery with any necessary endorsement or assignment." U.C.C. § 9-105(1)(I) (Emphasis added). See also U.C.C. [Revised] § 9-102(a)(47). The author has been informed that some lawyers are advising their secured creditor clients to require the client's debtor/borrowers to force its [the debtor's] account debtors to sign negotiable instruments in favor of the debtor/borrower that can, in turn, be possessed by the secured creditor. Under Article Nine, *possession* is a proper mode of perfection for a negotiable instrument regardless of the debtor's location. Even if the obligation captured in the instrument arose out of an account debtor's obligation to pay

“chattel paper.”⁴

As the next section explains, Revised Article Nine solves the categorical goods/intangibles problem in the current case law by defining software as a general intangible,⁵ and at the same time, expanding the

for the use of intellectual property, Article Nine perfection by possession should hold as applicable law. The decision in the *Peregrine* case concludes that the recording provisions of the Copyright Act displace Article Nine perfection with respect to copyright receivables. *National Peregrine, Inc. v. Capital Federal Savings & Loan Ass'n.*, 116 B.R. 194, 199 (C.D. Cal. 1990). However, this conclusion should not disturb the Article Nine rule on perfection of instruments by possession for two reasons:

1. The Ninth Circuit's decision in the *Broadcast Music* case seems to critically undermine the premise of *Peregrine* with respect to copyright receivables. *See Broadcast Music, Inc. v. Hirsch*, 104 F.3d 1163, 1166 (9th Cir. 1997) (“Assignments of interests in royalties have no relationship to the existence, scope, duration or identification of a copyright, nor to ‘rights under a copyright.’”).

2. In any case, the receivables rule in *Peregrine* should not reach an obligation once it is formed by the account debtor into a negotiable instrument. Such an obligation to pay losses much of its prior relationship with the consideration for the underlying obligation. It is transformed into an obligation to pay separate from its source and different from its prior intangible status as an “account” or “general intangible.” *See* U.C.C. § 9-304, cmt. 1; U.C.C. [Revised] § 9-313, cmt. 2. Instruments held as collateral are not collected routinely without the direct participation of the secured party. Except for temporary purposes, including presentment for collection, instruments must be in the possession of the secured party in order to be “perfected” against third party claims. U.C.C. § 9-304(1),(4)&(5). *But see* U.C.C. [Revised] § 9-312(a) (Instruments can be perfected by filing). Although a proper filing can perfect a security interest in an instruments under the Revisions, that form of perfection still leaves the secured party vulnerable to both ordinary course purchasers who give new value and to subsequent holders-in-due-course. U.C.C. [Revised] § 9-330(a) & § 9-331(a)&(c).

⁴ “Chattel paper” is another kind of documented right to payment that has its own collateral category under Article Nine. Rights to payment that arise out of intellectual property transfers will generally not be considered chattel paper because under the current Article Nine language, chattel paper must include a security interest or lease in specific *goods* in support of the monetary obligation running to the debtor who, in turn, wants to use this right to payment as collateral. U.C.C. § 9-105(1)(i). *See In re Latin Investment Corp.*, 156 B.R. 102 (Bankr. D.D.C. 1993). *Accord* U.C.C. [Revised] § 9-102(a)(47). However, because certain software products are treated as “goods” under the current Article Nine language, the documents evidencing a monetary obligation that is, in turn, secured by these products can qualify as the obligee/debtor’s “chattel paper.” Chattel paper is not created under Revised Article Nine when these kinds of documentary obligations are secured by software because software is defined as a “general intangible” under the Revisions. However, the definition of “chattel paper” is expanded by the Revisions to include collateral rights in “a security interest in or lease of specific goods or of *specific goods and software used in the goods.*” U.C.C. [Revised] § 9-102(a)(11)(Emphasis added). *See* U.C.C. [Revised] § 9-102(a)(42)&(75).

⁵ U.C.C. [Revised] § 9-102(a)(42).

definition of an "account" to include all income streams from the sale or licensing of intellectual property.⁶

The Draft version of Revised Article Nine that was approved by National Conference of Commissioners on Uniform State Laws at their July 30, 1998 meeting amended the "general intangible" definition by expressly adding the word "software" to this category of collateral.⁷ Revised Article Nine also includes the following definition of "software" in section 9-102(a)(75): "Software" means a computer program and any supporting information provided in connection with a transaction relating to the program. The term does not include a computer program that is contained in goods unless the goods are a computer or computer peripheral.⁸

The phrase "computer program" is critical to understanding the scope of the new "software" definition and thus the new definition of a "general intangible." Revised Article Nine does not define "computer program." However, the definition of "computer program" can arguably be borrowed from the more complete set of software-related definitions in the proposed Uniform Computer Information Transactions Act ("U.C.I.T.A.").⁹ Guided by these parallel U.C.I.T.A. definitions, "software" under the Article Nine Revisions includes "source code."¹⁰ If "source code" can safely be placed within the definition of a "general intangible" under new section 9-102(a)(42), then Revised Article Nine overrules those cases that treat computer source code as "goods" for Article Nine filing purposes.¹¹

⁶ U.C.C. [Revised] § 9-102(a)(2).

⁷ DRAFT FOR APPROVAL, REVISION OF UNIFORM COMMERCIAL CODE ARTICLE 9 - SECURED TRANSACTIONS § 9-102(a)(42)(National Conference of Commissioners on Uniform State Laws, July 24-31, 1998)(With Prefatory Note and Reporter's Notes). The definition of a "general intangible" in the Proposed Final Draft of Revised Article Nine, submitted earlier to the American Law Institute at its May 1998 meeting, expressly added only one category of collateral- a "payment intangible" - to the otherwise residual definition. PROPOSED FINAL DRAFT, UNIFORM COMMERCIAL CODE - REVISED ARTICLE NINE - SECURED TRANSACTIONS § 9-103(b) (Proposed Final Draft, April 15, 1998).

⁸ U.C.C. [Revised] § 9-102(a)(75). The term "computer program" is not defined in the final version of Revised Article Nine.

⁹ Formerly proposed U.C.C. Article 2B. *See* DRAFT, UNIFORM COMMERCIAL CODE - ARTICLE 2B - LICENSES § 2B-102(a)(6) (Discussion Draft, August 1, 1998).

¹⁰ *See supra* note 8.

¹¹ *Computer Servicenters, Inc. v. Beacon Mfg. Co.*, 328 F. Supp. 653, *aff'd*, 443 F.2d 906 (4th Cir. 1971); *Systems Design & Management Information, Inc. v. Kansas City Post Office Employees Credit Union*, 14 Kan. App.2d 266, 788 P.2d 878, 11 U.C.C. 2d 775 (1990); *Wharton Management Group v. Sigma Consultants, Inc.*, LEXIS 54 (1990), *aff'd* 582 A.2d 936 (Del. 1990); *Geotech Energy Corp. v. Gulf States Telecommunications & Information Systems, Inc.*, 788 S.W.2d 386 (Tex. App. 1990); *Micro-Managers, Inc. v. Gregory*, 147 Wis.2d 500, 434 N.W.2d 97 (Ct. App. 1988); *Data Processing Services,*

A number of cases have concluded that “software” in general and “source code” in particular, should be treated as “goods” under the Commercial Code. When this rule is applied, Article Nine forces the secured party to file in the location when the goods are located to perfect its interests. Finding the “situs” of some physical thing or embodiment that can reproduce itself and can thus have many locations, for example software and source codes, can be nearly impossible to determine.

Intangible property, however, is conceptually separate from its host embodiment. This principle has been recognized by the United States Supreme Court¹² and by Congress.¹³ Even when this duality of property principle is recognized, however, the distinction between intangible intellectual property and its tangible embodiment has been difficult for Courts to make in cases involving computer source code and software. The arrangement of commands in a source code has meaning only as it reacts to the physical capabilities of a particular machine. This interdependence has led one Bankruptcy Court to conclude that source code has no abstract existence apart from the *tangible* machines in which it effects *tangible* changes.¹⁴

Arguably the source code for any particular application acts like a mechanical key to unlock the capabilities of the hardware. These codes seem to be part of their host hardware. Nevertheless, this view ignores the reason why the source code has value as collateral. The primary value of the source code exists apart from any *single* machine. It derives its value from its usefulness as a command sequence for many similar machines. Without the ability to generate multiple copies of the source code it is a solitary hardware component. For the owner of the source code, the essence of the work's value is in the ability to generate multiple copies, or license others to do so.¹⁵ This ability and control functionally describes the protected intellectual property captured in the work. If the real value of source codes does indeed stem from the fact that the source codes contain a sequence of commands and other expressions capable of making many machines more useful, it is intellectual property separate from its embodiment, at least to the extent that the exclusive right to control such further use can be separately owned.¹⁶

Inc. v. L.H. Smith Oil Corp., 492 N.E.2d 1329, 1 UCC 29 (Ind. App. 1986).

¹² Stevens v. Gladding, 58 U.S. 447, 452 (1854).

¹³ 17 U.S.C. § 202 (1988).

¹⁴ See *In re Bedford Computer Corp.*, 62 B.R. 555, 567 (Bankr. D.N.H. 1986).

¹⁵ See *In re Information Exchange, Inc.* 98 B.R. 603, 604-05 (Bankr. N.D. Ga. 1989). (*Information Exchange* may go too far in the other direction by suggesting that the material object or copy has no separate value.)

¹⁶ *Advanced Marketing Services, Inc. v. Dayton Data Processing, Inc.*, 1992 Ohio App. LEXIS 994 p. 20 (Ohio App. 2d Dist., March 6, 1992). (“Transfer of ownership of any

Guided by this principle, Revised Article Nine defines “software” and classifies it as a “general intangible.”¹⁷

material object, including the copy or phonorecord in which the work is first fixed, does not of itself convey any rights in the copyrighted work embodied in the object....” The *AMSI* court concluded that a buyer of custom tailored software bought one copy of the software and documentation but that such purchase was separate and distinct from the rights of the copyright owner.)

¹⁷ U.C.C. [Revised] § 9-102(a)(42)&(75). Although the definition of “software” relies on the meaning of terms not defined in Revised Article Nine, the definition seems to include source code.

APPENDIX 9 - IN RE SSE INTERNATIONAL CORP.

*In re SSE International Corp.*¹ involved a contest between the trustee and a secured creditor of the licensor/debtor over the funds collected under a settlement agreement between the debtor and a third party/licensee who owed money *prior to the petition* under a license of the debtor's "know how."² The secured creditor's security agreement described and therefore reached the debtor's "accounts" but not the debtor's "general intangibles." The secured creditor argued unsuccessfully that the pre-petition license debt was an "account" because it was a "right to payment for goods sold or leased or for services rendered"³ However, the Bankruptcy Court concluded that the license covering know-how was neither a sale of goods nor the sale of a service, taking the pre-petition right to payment outside the current U.C.C. section 9-106 definition of an "account."⁴ The licensed know-how was not treated as "goods" because it was primarily ideas and concepts.⁵ Know-how was an intangible, like the *content* of a computer program or the *content* of a book, according to the Court in *SSE International*. The actual software and books, on the other hand, are media for ideas. These media can be "goods" if they are tangible, moveable and available in the marketplace.⁶ The Court also rejected the secured party's argument that in furnishing its know-how, the debtor rendered a "service." A service, explained the court, implied an undertaking to perform a "[d]uty or labor."⁷ For the debtor to have "served" the licensee, it would have had to *utilize* its know how for the licensee's benefit. Under the license in *SSE International*, the debtor provided no additional labor or assistance. Furnishing the licensee with know-how alone was not a service according to the Court because "the

¹ 198 B.R. 667 (Bankr. W.D. Pa. 1996).

² 198 B.R. at 668.

³ *Id.*; See also U.C.C. § 9-106.

⁴ If the pre-petition debt itself was collateral covered under the security agreement, the settlement paid to the trustee should go to the secured party as "proceeds" of the secured party's pre-petition collateral. In fact, unless the settlement money was "proceeds" of pre-petition collateral, section 552(a) of the Bankruptcy Code would prevent the secured party from claiming it or any other property acquired by the debtor or by the bankruptcy estate after the petition was filed, even where the post-petition property is duly described in the security agreement. 11 U.S.C. § 552(a)&(b) (1994). See *In re Specialty Foods of Pittsburgh, Inc.*, 98 B.R. 734, 736-37 (Bankr. W.D. Pa. 1989).

⁵ 198 B.R. at 669-70.

⁶ *Id.* at 670.

⁷ *Id.* at 671.

debtor's initial act of creating its 'know how' was undertaken for its own benefit rather than to satisfy a duty to [the licensee], or anyone else"⁸ The Court explained that "[f]or an act of creating know how to constitute a rendering of services, or an account generating performance, it must be undertaken for the benefit and/or at the behest of someone else (i.e., one cannot render services to oneself.)"⁹ The *SSE International* Court fails to distinguish the act of creating know how from the act of sharing that know how with the licensee. However, its predicate requirement that service be in some sense servile would seem to prevent even the sharing of know how from being classified as a service. Other licenses of know how might be more proactive in terms of the licensor's obligation than the license in *SSE International*, however. If the licensor's advisory role is more hands on, the licensee's resulting payment obligation could arguably be viewed as an "account" under the *SSE International* test. The moral of the story for a secured party financing a debtor who is licensing intellectual property is that the security agreement should include the debtor's "accounts" and "general intangibles" as well as the proceeds of both.¹⁰

⁸ *Id.*

⁹ *Id.*

¹⁰ It is not enough to include both accounts and general intangibles when they are described as "rights to the payment of money" because that kind of limitation in the description covers only the various income streams that may be generated by licensing; it does not cover the ownership right in the intellectual property proper (i.e., the ownership of the exclusivity right, itself). If the intellectual property right itself is not included in the security agreement description, the proceeds of a post-bankruptcy assignment or license of that right will not go to the secured party even though the after-acquired income from the assignment does fall within the "right to payment" description in the security agreement. Section 552 of the Bankruptcy Code makes after-acquired property clauses unenforceable after the petition is filed, except when the property acquired is also the "proceeds of collateral that was covered by the security agreement prior to the petition." See *In re Specialty Foods of Pittsburgh, Inc.*, 98 B.R. 734, 736-37 (Bankr. W.D. Pa. 1989).

APPENDIX 10 - COMMERCIAL TORT CLAIMS

Because “commercial tort claims” under the Revisions have characteristics that require special handling, secured creditors must be careful to distinguish infringement claims offered separately as original collateral (special handling required) from those claims that become collateral because they are the “proceeds” of general intangible collateral already held by the secured creditor.¹ The new definition of “proceeds” in Revised section 9-102(a)(64) expressly includes “claims arising out of the loss, . . . infringement of rights in, or damage to, the collateral.”² Under Revised section 9-315(a)(1), the security interest in the underlying intellectual property collateral “attaches” to the infringement claim “proceeds.”³ Even if they are not mentioned in the security agreement, infringement claims (or “commercial tort claims”) will pass as “proceeds” of their underlying intellectual property (e.g., patents, trademarks, and copyrights) as long as that property is effectively covered as collateral. Such a “proceeds” claim cannot exceed the value of the underlying collateral “damaged” by the infringement, however.⁴

Note that even if the security interest in the underlying collateral is perfected by a federal recording (e.g., copyright collateral) the security interest in a related infringement claimed as “proceeds” continues to be perfected under the Revisions if the secured party has filed a financing statement covering the original collateral and the proceeds are collateral that may be perfected by a filing “in the office in which the financing statement has been filed.”⁵ Revised section 9-315(d)(1)(A) only requires that an existing Article Nine filing “covers the original collateral,” it need not “perfect” as to that original collateral. Therefore, even if a state filing on original copyright collateral did not perfect as to such collateral because the Copyright Act recording provisions displaced Article Nine, the Article Nine filing on the copyright collateral should still serve to hold infringement claim “proceeds.”⁶

Secured parties considering “commercial tort claims” as collateral

¹ Section 9-109(d)(12) makes the proceeds rule in section 9-315 and the priority rules in Section 9-322 applicable to tort claims otherwise excluded from Revised Article Nine. U.C.C. [Revised] § 9-109(d)(12).

² U.C.C. [Revised] § 9-102(a)(64)(D).

³ U.C.C. [Revised] § 9-315(a)(2).

⁴ U.C.C. [Revised] § 9-315, cmt. 2.

⁵ U.C.C. [Revised] § 9-315(d)(1)(A)&(B).

⁶ U.C.C. [Revised] § 9-315(d)(1)(A).

must distinguish claims for infringement to federal intellectual property from claims based on federal law that are unrelated to any underlying federal intellectual property right. Under Revised Article Nine, an action under section 43(a) of the Lanham Act alleging infringement or injury to trademark property already held as “general intangible” collateral should automatically pass to the secured party as “proceeds” of the collateral.⁷ However, an unrelated section 43(a) action for unfair competition, not tied to the protection of separately recognized trademark property would only be a “commercial tort claim.” Such a “claim” is personal property under the Revisions, but is not within the new definition of a “general intangible.”⁸ Furthermore, the *unrelated* “commercial tort claim” could not be “proceeds” derived from the protection of a recognized *property right* (e.g., a form of intellectual property that qualifies as a general intangible).⁹ Such an unrelated “commercial tort claim” would have to stand on its own as a separate and high-maintenance form of Article Nine collateral. Standing alone, such “claims” may be difficult for a secured party to obtain and hold. These claims must be specifically described in the security agreement. Indication by category or by type is inadequate.¹⁰ Furthermore, the Revisions provide that “commercial tort claims” cannot be acquired by the secured party under an after-acquired property clause.¹¹ Therefore, an unrelated section 43(a) “claim” can only serve as collateral after the cause of action arises and after it is transferred under specific language to the secured party. It must be noted, however, that as soon as a debtor’s commercial tort claim is settled and thus reduced to a contractual obligation, the debtor’s contractual right to payment becomes a “payment intangible.”¹² Unlike a “commercial

⁷ U.C.C. [Revised] § 9-102(a)(64)(D) (“to the extent of the value of the collateral, claims arising out of the loss, nonconformity, or interference with the use of, defects or infringement of rights in, or damage to, the collateral”). See also U.C.C. [Revised] §§ 9-109(d)(12) & 9-315.

⁸ U.C.C. [Revised] § 9-102(a)(42).

⁹ An action under section 43(a) of the Lanham Act is not limited to cases involving injury to the plaintiff’s mark. 15 U.S.C. § 1125(a) (Supp. 1999). The action lies even for allegedly false statements about a competitor’s own product. At least one court has concluded that in this context, there is no constitutionally protected property right to be free of false advertising. *College Savings Bank v. Florida Prepaid Postsecondary Education Expense Board*, 131 F.3d 353, 360 (3d Cir. 1997) (“The only cognizable property right that could be involved would be a right to be free of false advertising, a right that is *not an intangible property right* protected under the Fourteenth Amendment.”) (Emphasis added).

¹⁰ U.C.C. [Revised] § 9-108(e)(1).

¹¹ U.C.C. [Revised] § 9-204(b)(2).

¹² U.C.C. [Revised] § 9-109, cmt. 15.

tort claim,” a payment intangible need not be specifically described in the security agreement and can be acquired under an after-acquired property clause.¹³

¹³ *Id.* U.C.C. § 9-102(a)(61)(“Payment intangible” means a general intangible under which the account debtor’s principal obligation is a monetary obligation”).

APPENDIX 11 – INTELLECTUAL PROPERTY AS COLLATERAL

The concept of “title” is more central to rights in intellectual property than it is to rights in tangible collateral, such as goods. As Judge Nott observed more than 100 years ago: “[t]hough the most intangible form of property, it [intellectual property] still, in many characteristics, is closer in analogy to real than to personal estate. Unlike personal property, it cannot be lost or found; it is not liable to casualty or destruction; it cannot pass by manual delivery. Like real property, it may be disposed of, territorially, by metes or bounds; it has its system of conveyancing by deed and registration; estates may be created in it, such as for years and in remainder; and the statutory action for infringement bears a much closer relation to an action of trespass than to an action in trover and replevin. It has, too, what the law of real property has, a system of user by license.”¹

Both legal and equitable title to a patent, for example, carry their own distinct rights.² A parol assignment of a patent or patent application will not convey legal title, but it is generally sufficient to convey equitable title once the patent issues or the application is filed.³ Similarly, a written *agreement to assign* an existing application or an existing patent vests equitable title in the promisee.⁴ In general, a debtor with this kind of equitable title in an existing patent should have sufficient rights for purposes of “attachment” under section 9-203 of Article Nine. However, these examples of equitable rights in an *existing* application or *existing* patent that pass under an oral assignment or an agreement to assign must be distinguished from another very different patent law use of the phrase “equitable title.” This other use of “equitable title” arises in connection with the *present status* of an assignee of an “expectant interest.” Even before the existence of the invention, a *present* written assignment of the inventor's rights is effective to convey an expectant interest to the assignee.⁵ The assignee of such an expectant interest does not acquire legal title to a patent application until the application is filed and does not acquire legal title *to the*

¹ A.S. Solomons v. United States, 21 Ct. Cl. 479, 483 (1886), *aff'd*, 137 U.S. 342 (1890).

² *Compare* FilmTec Corp. v. Allied-Signal Inc., 19 U.S.P.Q.2d 1508, 1511-12 (Fed. Cir. 1991), *with* Arachnid, Inc. v. Merit Industries, Inc., 939 F.2d 1574, 1580, 19 U.S.P.Q.2d 1513, 1517 (Fed. Cir. 1991).

³ See E. Lipscomb, 5 WALKER ON PATENTS § 19:4 & § 19:28 (1986).

⁴ Arachnid, Inc. v. Merit Industries, Inc., 939 F.2d 1574, 1580, 19 U.S.P.Q.2d 1513, 1517 (Fed. Cir. 1991).

⁵ 19 U.S.P.Q.2d at 1511-12.

patent until the patent issues.⁶ The Federal Circuit has recently described these “expectant” rights of a present assignee of future patents as “at most an equitable title,” that vests legal title in the assignee after the “invention is made and an application for patent is filed.”⁷ This use of the phrase “equitable title” to describe an inchoate right to property not yet in existence should not be confused with the previous examples of equitable title to *existing* intangible rights. Rights in the collateral under section 9-203 should not arise until the patent property exists in a form capable of legal or equitable *ownership*. Once the patent property has existence, however, the prior assignee of an expectant interest gets both legal and equitable title and sufficient “rights in the collateral” for attachment to occur.

(1) Rights in Light of Metamorphosis of Collateral

As the discussion in the prior section suggests, a debtor’s Article Nine “rights” in patents and other forms of titled intellectual property will depend more on the state of title rather than other evidence of ostensible ownership. However, the concept of “rights in the collateral” under section 9-203 does not mean all rights or complete rights. Some of the section 9-203 “attachment” cases involving goods have found that the debtor had enough *pre-title* collateral rights at the point in time when particular goods were “identified” to the contract of sale under section 2-501(1).⁸ If one assumes that legally titled intellectual property is “all rights,” and that a recognized form of “equitable” title to *existing* intellectual property may be “significant rights,”⁹ then it is arguable that the existence of an incomplete, but

⁶ Bailey v. Chattem, Inc., 684 F.2d 386, 389-92 (6th Cir. 1982).

⁷ FilmTec Corp. v. Allied-Signal Inc., 19 U.S.P.Q.2d 1508, 1511-12 (Fed. Cir. 1991).

⁸ See, e.g., Rex Financial Corp. v. Mobile America Corp., 119 Ariz. 176, 580 P.2d 8, 23 UCC 788 (App. 1978); *In re* Transportation Design & Tech., 48 B.R. 635, 641 (Bankr. S.D. Cal. 1985). “Identification” of goods to the buyer’s contract under U.C.C. section 2-501 gives the buyer certain specific rights in the goods. See U.C.C. § 2-502 & 2-716(3). At least one court has concluded that these rights alone may be enough to satisfy section 9-203(1)(c). Johnson v. Conrail-Amtrak Federal Credit Union, 37 UCC 933 (D.C. Super. 1983). See also Trust Company Bank v. Gloucester Corp., 419 Mass 48, 52, 643 N.E.2d 16, 18 (1994) (“These incidents [a degree of control and an insurable interest under U.C.C. § 9-501] were sufficient to allow the defendants’ security interests to attach to the scallops and to make the plaintiff’s rights subordinate to the defendants’ liens in the absence of the plaintiff having a perfected purchase-money security.”).

⁹ PRELIMINARY REPORT #1: AN OVERVIEW OF THE CURRENT LEGAL RULES AND STRUCTURES GOVERNING THE PERFECTION AND PRIORITY OF SECURITE INTERESTS IN INTELLECTUAL PROPERTY AND ANALYSIS IF PROPOSED LEGISLATIVE REFORMS, SECTION II (B)(3)(A). (Cooperative Contract - U.S.P.T.O. and Franklin Pierce Law Center 2000).

recognized, *preliminary* form of the debtor's intellectual property may also be "sufficient rights" to mark the point of the secured party's section 9-203 attachment.

The prior discussion concludes that intellectual property must have some definable legal existence before any "rights" can be acquired by the debtor.¹⁰ A debtor's good idea alone is not a "general intangible." Likewise, the present assignment to the debtor of an "expectant" interest cannot yield rights until the assigned property exists. Once the inventing debtor's conception or the assignee debtor's expectant interest is captured in an recognized form (e.g., a patent application), the issue is whether the debtor acquires rights, not only in that first protected form, but in any subsequent metamorphosis of that form into another protected form of intellectual property.¹¹ For example, a patent application is a form of intellectual property to which a security interest can attach.¹² If the debtor files a patent application or acquires a patent application by assignment, does that debtor have sufficient rights in the application itself as well as sufficient "rights" *in the patent* that may eventually be granted for purposes of section 9-203(1)(c). This example can be extrapolated further when one considers that an undisclosed trade secret may take on a more documented form when it becomes the subject of a patent application. The patent application, in turn, may be transformed into an issued patent after the successful completion of the patent prosecution process.¹³ The idea first protected as a trade secret could evolve into public information protected under the Patent Act.

¹⁰ *Id.*

¹¹ The continuation of a security interest in tangible property through various changes in classification has been given judicial sanction. See, e.g., *In re Robert Bogetti & Sons*, 162 B.R. 289, 294 (Bankr. E.D. Cal. 1993) ("Once a security interest attaches to described collateral, subsequent transmutations as to classification under section 9-109 do not defeat that security interest.") *In re Walkington*, 62 B.R. 989 (Bankr. W.D. Mich. 1986). These cases deal with changes in the *use* of existing tangible property, however, not with *new forms* of property.

¹² See *In re Williams*, 167 B.R. 77, 80-81 (Bankr. N.D. Miss. 1994) (No security interest in a certificated security can be obtained until the stock is issued. However, the stock *subscription* is a general intangible in which a security interest can be obtained and perfected by filing.) Under the current precedent, a patent is not even the "proceeds" of a patent application, however. The applicant does not obtain the patent by "disposing" of the application within the meaning of U.C.C. section 9-306(1). *In re Transportation Design & Tech.*, 48 B.R. 635, 641 (Bankr. S.D. Cal. 1985). But see U.C.C. [Revised] § 9-102(a)(64) & § 9-315(a)(1) (adopting a substitution of value test for "disposition"). See discussion in PRELIMINARY REPORT #1, *supra* note 9 at Section II(c)(2)(B).

¹³ The relative merits of the trade secret and the patent as alternative forms of protection for the same technology are discussed in 1 P. Rosenberg, *PATENT LAW FUNDAMENTALS* § 3.07 (2d ed. 1990).

A court could refuse to adhere to the title theory outlined in the last section and rather, hold that the patent application itself *does* confer patent "rights" on the debtor, or at a minimum "rights" closely related to the patent which *may* eventually issue. Arguably, when an inventor files a patent application, the filing of the application creates a one-year period during which public disclosure or commercial use of the invention will not be a statutory bar to obtaining the patent.¹⁴ This right might be viewed as a significant right *in the patent itself*. From that premise, a secured party could successfully argue that its debtor acquires sufficient section 9-203 "rights" *in the patent* from the time a patent application is filed.

In most cases this analysis may not be critical to a secured party as long as the patent, if and when it is granted, can be considered the "proceeds" of the patent application. This issue is discussed. The timing of attachment under Article Nine and early acquisition of "rights" by the debtor is often important in the context of the Bankruptcy Code. *The Matter of Transportation Design and Technology, Inc.* illustrates the importance of early "attachment" to a secured creditor.¹⁵

In *Transportation Design*, the secured party had a security interest in all of the corporate debtor's "general intangibles," including those intangibles acquired after the date of the security agreement. These intangibles consisted of patents on wheelchair lifts that were assigned to the corporate debtor by two of its former officers. The debtor was the titled owner of some of these previously assigned patents at the time it filed for bankruptcy. One of the points of controversy in the case, however, involved a patent on a wheelchair lift that did not issue until after the bankruptcy petition was filed. The application for this patent was filed by the inventors, the former corporate officers, *prior* to the bankruptcy filing date. The issued patent itself was never assigned to the bankrupt debtor. It does not appear that the patent application was ever assigned either, the Court's eventual holding, however, creates a great deal of confusion on this point.

The secured party's claim to this post-petition patent and the trustee's opposition to that claim seem to be based on the assumption that the patent eventually *became* the debtor's after-acquired "general intangible." The trustee in bankruptcy sought to have this post-petition patent included in the debtor's bankrupt estate and, at the same time, the trustee opposed the secured party's claim to the patent as collateral. The trustee treated the patent as after-acquired property of the debtor but argued that under section 552 of the Bankruptcy Code the patent was "property acquired . . . by the debtor after the commencement of the case," and therefore, "not subject to any lien

¹⁴ 35 U.S.C. § 102(b) (1988). *In re Kaslow*, 707 F.2d 1366, 217 U.S.P.Q. 1089 (Fed. Cir. 1983). The "filing date" of a patent application is defined in 37 CFR § 1.53(b) (1992).

¹⁵ 48 B.R. 635, 640, 40 UCC 1393, 1399-1400 (Bankr. S.D. Cal. 1985).

resulting from any security agreement entered into by the debtor before the commencement of the case.”¹⁶

The secured party countered with two alternative arguments: (1) the debtor had section 9-203 *rights* in the post-petition patent prior to the commencement of the case; and, (2) the post-petition patent was "proceeds" of the pre-petition patent application under the section 552(b) exception from the 552(a) bar to consensual after-acquired security under the Bankruptcy Code.

The argument for early attachment seems based on the premise that some "rights" in a patent can exist before it actually issues. *If* the inventors agreed to assign the patent to the debtor, then arguably the debtor had "rights" in the patent from the time of the agreement or from the date of the patent application, whichever came *later*. Since the patent application was filed before the petition, the security interest "attached" to the patent *before* it was issued and *before* the bankruptcy petition was filed.

The Court in *Transportation Design* might have simply rejected this extravagant attempt to pre-date the debtor's rights in the patent by holding that no "rights" in a patent can arise before the patent is issued. Rather, the Court rejected the secured party's claim on the basis that it failed to prove that the inventors ever agreed to assign either the patent or the patent application to the debtor.¹⁷ It appears that the Court's conclusion not only undermined the secured party's attempt to avoid the bar in section 552(a), it also undermined any subsequent interest of the corporate debtor in the post-petition property. Nevertheless, the Court stated its conclusion in a way that recognized the corporate debtor's interest. In the Court's words, the secured party failed to carry the "... burden of establishing its security interest *in property of the debtor*"¹⁸ While the Court's opinion avoided the time of attachment issue with some questionable logic, the dicta in *Transportation Design* suggests that, if a patent has been applied for, a clearly established agreement to assign the patent might give the assignee "rights in the collateral" before the patent is issued. *Transportation Design* leaves open the possibility that a debtor could acquire rights in a patent from the time of the filing of the patent application if the application was filed by the debtor.¹⁹

¹⁶ 48 B.R. at 650. See THOMAS M. WARD, INTELLECTUAL PROPERTY IN COMMERCE § 2:23 (2000); See also 11 U.S.C. § 552(a) (1988).

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ A 1992 District Court decision that arose out of a bankruptcy case concluded that an after-acquired property clause covering "...contract rights...and patents now owned or hereinafter acquired," gave the secured party an attached interest in the debtor/assignee's *patent application* at the moment it was assigned to the debtor by the assignor. *Chesapeake Fiber Pkg. v. Sebro-Packaging Corp.*, 143 B.R. 360, 365, 368, 23 U.S.P.Q.

Such an inference from the dicta in *Transportation Design* would be unfortunate, however. The baseline title theory should hold on these facts. The Court should have disposed of the secured party's attempt to advance the "attachment" time of its after-acquired property claim to the post-petition patent by holding that no "rights" can arise in a patent until it issues. The patent itself is still very contingent when the application is filed.²⁰ Unlike identified yet undelivered goods, which have a certain existence, the patent may never issue from the application. An alternative approach, recognizing "rights" at full title (or at least equitable title in an existing right) should be used as a guide to "attachment" when the collateral is federal intellectual property.²¹ The debtor has no title in a patent until it issues in the debtor's name, or until it is issued to another owner and the debtor acquires at least an equitable title by transfer from that owner.²² The patent application is properly viewed as a separate intangible asset of the debtor, not as a piece of, or right in, the contingent unissued patent.

An innovation may be protected as a trade secret and as such be a form of intellectual property collateral. However, the debtor's ownership of a trade secret does not give the debtor "rights" in either a subsequent patent application covering the same innovation or in the subsequent patent, which may issue from the application.²³ Under the authority of section 9-204, the security agreement may provide that the debtor's subsequently acquired right (e.g., an issued patent) in the same innovation passes automatically to the secured party as after acquired property.²⁴ Similarly, prior state law rights in an unfixed work should not give the debtor rights in a federal statutory copyright.²⁵ In the same manner as patents, however, an after-acquired property clause which covers "copyrights" should allow the secured party to pick up both forms of intellectual property once the debtor's discrete rights in each arise.²⁶

Trademarks present an interesting challenge for the secured party

1522, 1525&1528 (D. Md. 1992), *aff'd*, 1993 U.S. App. LEXIS 28605 (4th Cir. 1993).

²⁰ PTO, Managing Change For Global Challenges - Fiscal Year 1996: A Patent and Trademark Office Review 100 (1997).

²¹ See *Hong Kong & Shanghai Banking Corp., Ltd. v. HFH USA Corp.*, 805 F. Supp. 133, 19 UCC 2d 855 (W.D.N.Y. 1992).

²² *FilmTec Corp. v. Allied-Signal, Inc.*, 939 F.2d 1568, 1572 (Fed. Cir. 1991).

²³ See *Nye Tool & Machine Works v. Crown Die & Tool Co.*, 276 F. 376 (7th Cir. 1921).

²⁴ *Chesapeake Fiber Pkg. v. Sebro Packaging Corp.*, 143 B.R. 360, 365, 368, 23 U.S.P.Q. 1522, 1525&1528 (D. Md. 1992), *aff'd*, 1993 U.S. App. LEXIS 28605 (4th Cir. 1993).

²⁵ 17 U.S.C. § 301(b)(1) (1994).

²⁶ The preemption of Article Nine when federal intellectual property is involved is discussed in PRELIMINARY REPORT #1, *supra* note 9 at Part III.

trying to measure the debtor's rights for attachment purposes. State common law trademark protection depends on the debtor's *adoption* and *use* of a distinctive mark. Normally, the debtor would acquire state law rights in the mark *before* it was entitled to registration under the federal statute.²⁷ However, since the 1988 amendments to the Lanham Act, a debtor may acquire inchoate federal trademark property rights under an "intent to use" application before acquiring state common law rights through actual use.²⁸

Under the Article Nine concept of "rights in the collateral" the secured party should be able to claim an attached interest in the debtor's right in a mark protected under an "intent to use" application before the mark gives rise to any rights under state law. However, under section 10 of the Trademark Act²⁹ no "intent to use" application shall be assignable prior to the filing of a verified statement of use unless the assignee succeeds to all or part of the assignor's business.³⁰ In *Clorox Co. v. Chemical Bank*,³¹ the Trademark Trial and Appeal Board held that an outright pre-use *assignment* of an "intent to use" application to a lending bank as part of a larger loan and security agreement is prohibited. The remedy greatly impacted both the lending bank and the debtor. Although the Bank pleaded with the Appeal Board to merely ignore the prohibited assignment of the intent to use application and render their security interest ineffective, the Board found that the proper remedy was to invalidate the debtor's certificate of registration.³²

²⁷ 15 U.S.C. § 1051 (1988).

²⁸ 15 U.S.C. 1051(b) (1988).

²⁹ 15 U.S.C. § 1060 (1994).

³⁰ This restriction, designed to insure that the intention of the "intent to use" applicant is bona fide and to prevent trafficking in marks was added by the Trademark Law Revision Act of 1988, Public Law 100-667 (102 Stat. 3935), November 16, 1988.

³¹ 40 U.S.P.Q.2d 1098 (1996).

³² 40 U.S.P.Q.2d at 1105-06. The assignment in *Clorox* was worded as an unconditional transfer with an obligation on the assignee to reassign within 30 days after the obligation was satisfied. The Appeal Board emphasized that the language of the assignment was "outright, rather than conditional" *Id.* at 1103. This absolute assignment with a license back and a duty to reassign on satisfaction is typical of the language in a collateral assignment of a trademark. Because transfers of trademarks "in gross" without associated goodwill are invalid, a present collateral assignment with a license back is a problematic security device even when "intent to use" applications are not involved. See *Haymaker Sports, Inc. v. Turian*, 581 F.2d 257 (C.C.P.A. 1978). See generally Simensky, *Enforcing Creditors' Rights Against Trademarks*, 79 TRADEMARK REP. 569, 570-78 (1989). However, *conditional* assignments, in general, have been given a degree of legitimacy by the PTO filing rules. 37 C.F.R. §§ 3.1, 3.11 & 3.56 (1994). There is, however, case law authority for the point that the internal largess of the PTO cannot expand the narrow constructive notice limits on the section 1060 mandate to record "assignments." *In re 199Z*, 137 B.R. 778, 782 at n.7 (Bankr. C.D. Calif. 1992). The

However, the Board observed that a transfer of a mere Article Nine security interest in a mark would *not* be considered an unconditional "assignment," and would not provoke the penalty for trafficking imposed in *Clorox*.³³ Intent to use applications can be properly taken as collateral under Article Nine. A debtor with an "intent to use" application does have section 9-203 "rights" in a form of trademark property that can be transferred to one who succeeds to the debtor's business or a portion thereof in the event of default, foreclosure and sale. This transferable interest should be sufficient for purposes of attachment under section 9-203. Because attachment is the necessary predicate for perfection, an Article Nine security interest in an intent to use application can be made safe against the strong-arm powers of the trustee in bankruptcy.³⁴ While there is some uncertainty about subsequent purchasers of the intent to use application who are eligible assignees under the Lanham Act because they also succeed to all or part of the debtor's business,³⁵ Article Nine perfection should be sufficient protection in this situation as well.³⁶

1988 Trademark Revision Act made extensive revisions to the federal trademark registration system. Pub. L. 100-667, 102 Stat. 3938 (Nov. 16, 1988), *codified at* 15 U.S.C. § 1053 *et seq.* (1994). An earlier version of the legislation contained a detailed set of rules governing the recording and priority of security interests in federal trademarks which would have preempted most of the Article Nine system. S. 1883, 100th Cong., 1st Sess. § 10(b)-(f) (1987), 133 Cong. Rec. S 16548-49 (Nov. 19, 1987) (unenacted). A recorded security interest was given priority over "interests subsequently granted." *Id.* at § 10(b). This ambitious provision was dropped from the final enacted version of the 1988 Act. In its current form, the Lanham Act makes no provision for security interests. Again, the dependent nature of the typical trademark transfer, and the absence of a title-related tradition around the taking of trademarks as collateral, make it hard to find a "security interest" within the section 1060 concept of an "assignment."

Our domestic law prohibiting assignments-in-gross is in some jeopardy. Among the many provisions of the NAFTA Treaty affecting intellectual property is Article 1708:11, calling for the elimination of prohibitions on assignments-in-gross. North American Free Trade Agreement, opened for signature Dec. 8, 1992, 32 I.L.M. 605, art. 1708:11 [hereinafter NAFTA Treaty]; Agreement on Trade-Related Aspects of Intellectual Property Rights, Including Trade in Counterfeit Goods, Dec. 15, 1993, 33 I.L.M. 81, art. 21 [hereinafter TRIPs Agreement]. The implementing legislation is silent on the issue, however. H.R. 3450, 103d Cong., 1st Sess., 139 Cong. Rec. S16712-13 (1993) (enacted). Without implementing legislation on NAFTA article 1708:11, assignments-in-gross remain prohibited under U.S. law.

³³ *Roman Cleanser Corp. v. National Acceptance Co. of America*, 43 B.R. 940 (Bankr. E.D. Mich 1984), *aff'd* 802 F.2d 207 (6th Cir. 1986).

³⁴ 11 U.S.C. § 544(a) (1984).

³⁵ See discussion *supra* at note 32.

³⁶ U.C.C. § 9-301(1)(d). *Accord* U.C.C. [Revised] § 9-317(d). In light of the *Clorox* case, it would be extremely unwise for the secured party seeking additional protection to take a

(2) Rights in Collateral as Affected by Derivative Title**(a) BFPs of Federal Intellectual Property**

In general, a secured party cannot have a right in collateral, which extends beyond the debtor's interest or "right" in that collateral. This rule, although not always applicable when the collateral is "goods," is universally applicable when the collateral is the debtor's intellectual property.

A debtor can occasionally transfer greater rights *in goods* than the debtor owns. Because possession of goods often equates with ostensible ownership, the derivative title predicate sometimes gives way to exceptions based in the concepts of fraud and estoppel.³⁷ Within the language of the Code itself, section 2-403 recognizes that a "purchaser" of goods may acquire good title where the transferor's title is voidable due to the transferor's fraud in acquiring possession in a prior transaction of purchase.³⁸ Under U.C.C. sections 1-201(32) and (33), the secured party enjoys the status of a "purchaser."³⁹ The Article Nine cases interpreting section 9-203(1)(c) occasionally apply these doctrines of fraud or estoppel in order to provide the secured party with collateral rights in goods that are greater than the debtor's actual ownership rights.⁴⁰ While these principles of fraud and

title-bearing assignment of an "intent to use" application.

³⁷ U.C.C. § 1-103.

³⁸ U.C.C. § 2-403(1)(A person with voidable title has the power to transfer good title to a good faith purchaser for value.); U.C.C. § 2-403(2)(A merchant entrusted with goods, of the kind with which she normally deals, can transfer the rights of the entruster to an ordinary course buyer.)

³⁹ U.C.C. § 1-201(32)&(33).

⁴⁰ *Swets Motor Sales, Inc. v. Puisner*, 236 N.W.2d 299 (Iowa 1975); *Uniroyal, Inc. v. Michigan Bank, N.A.*, 12 UCC Rep. Serv. 745 (Mich. Cir. Ct. 1972). The debtor may acquire rights in the collateral because the seller or owner has made it appear that the debtor owns the goods and is therefore estopped to deny that the debtor has acquired rights. *Kinetics Technology International Corp. v. Fourth Nat. Bank of Tulsa*, 705 F.2d 396, 36 UCC 292 (10th Cir. 1983); *In re Pubs, Inc.*, 618 F.2d 432, 28 UCC 297 (7th Cir. 1980). *Amfac Mortgage Corp. v. Arizona Mall*, 127 Ariz 70, 618 P.2d 240, 30 UCC 744, 749-50 (Ct. of App. 1980). Circumstances might suggest that a debtor in possession of goods is not the true owner. *Chrysler Corp. v. Adamatic, Inc.*, 59 Wis. 2d 219, 208 N.W.2d 97, 12 UCC 849 (1973); *In re Medomak Canning Co.*, 25 UCC 437 (Bankr. D. Me. 1977) (debtor held under a bailment for processing the goods). See Ward, *Defining the Article Nine Security Interest: The Old Problem and a New Solution*, 3 MAINE BAR J. 206, 208-210 (July 1988). Revised Article Nine expressly recognizes that section 9-203 collateral "rights" include "the power to transfer rights in the collateral." U.C.C. [Revised] § 9-203(b)(2).

estoppel underlying section 2-403 are not limited to goods, the goods cases provide the prototype for deriving principles of apparent ownership based on possession. These voidable title and apparent ownership concepts are not relevant to cases involving intangible property. In the case of a transfer of intellectual property, record existence of titled rights is determinative.⁴¹ With an awareness of the voidable title cases involving goods, Revised Article Nine recognizes that the debtor has rights in the collateral whenever the debtor has "the power to *transfer* rights in the collateral."⁴²

A debtor/transferee of a copyright or patent, for example, is subject to a federal recording statute. These federal recording anchor the derivative title principle in Article Nine. Unlike the ownership of goods, the secured party's *debtor* must record or register under federal law in order to preserve its ownership rights in intellectual property against subsequent parties.⁴³ To the extent that the debtor's unrecorded title may be defective, the derivative rights of the debtor's secured party will also suffer the same defect.⁴⁴

⁴¹ The "goods" related Articles of the U.C.C. specifically incorporate the idea of voidable title. See U.C.C. § 2-403 & § 2A-304. Note, however, that these concepts have not been included in those sections of the proposed Uniform Computer Information Transactions Act [formerly Draft U.C.C. Article 2B] pertaining to the transfer of intangible rights. See Draft U.C.I.T.A. § 2B-507(b) (Draft, February 1, 1999). Subsection (b) provides that a transferee of a license acquires only those rights that the licensee was authorized to transfer. This is an important principle under intellectual property law, which differs from transactions involving sales of goods. It comes from the fact that one of the property rights created under copyright law is the exclusive right to distribute a work in copies. A transferee who receives a transfer not authorized by the rights holder does not acquire greater rights than its transferor was authorized to transfer, even if the acquisition was in good faith and without knowledge. The basic fact is that, as regards property rights, if the transfer was unauthorized it was itself a violation of the property rights of the copyright owner. The ideas of entrustment and bona fide purchase, which play a role in dealing with title to goods, have no similar role in intellectual property law. Neither copyright nor patent laws recognize concepts of protecting a buyer in the ordinary course (or other good faith purchaser) by giving that person greater rights than were authorized to be transferred. Copyright law allows for a concept of "first sale" which gives the owner of a copy various rights to use that copy, but the first sale must be authorized. Draft U.C.I.T.A. § 2B-507, Reporter's Note 2 (Discussion Draft, February 1, 1999). Notwithstanding the Reporter's Note attached to proposed section 2B-507, estoppel principles may still be applicable in cases where the real owner of an intangible right acquiesces to the appearance of title in a pretending transferor without actual title. See, e.g., *TMT North America, Inc. v. Magic Touch GmbH*, 124 F.3d 876, 884-85 (7th Cir. 1997).

⁴² U.C.C. [Revised] § 9-203(b)(2)(Emphasis added.).

⁴³ 35 U.S.C. § 261 (1994); 17 U.S.C. § 205 (1994); 15 U.S.C. § 1060 (1994).

⁴⁴ J. White & R. Summers, *UNIFORM COMMERCIAL CODE* § 24-1 at 854 (4th ed. 1995)(The common law "shelter" rule is grafted into Article Nine through the operation of section 1-103 and section 2-403(1). It provides that a buyer gets as good a title as its seller had.)

Article Nine "attachment," however, does not require invulnerable title. When debtor's interest is unrecorded and thus vulnerable,⁴⁵ that debtor may never the less acquire section 9-203(1) "rights" in patents and copyrights sufficient for "attachment" and "perfection." The resulting attachment, however, only gives a secured party an interest in the "rights" which that debtor actually owns. If the debtor's failure to record in the Copyright Office or with the PTO results in a later displacement of the debtor's title in favor of a subsequent owner, the debtor's secured party and the debtor's other creditor will also be displaced, notwithstanding an existing "attachment" of the security interest.⁴⁶

For example, a debtor can acquire an assignment of a copyright. Even though that assignment is not recorded, it gives the assignee/debtor sufficient "rights" in the collateral to support an attached, perfected, security interest in favor of a secured party whose security agreement and financing statement cover "general intangibles."⁴⁷ Such "rights in the collateral" can be displaced, however, if the assignee/debtor fails to properly record that assignment within either the one-month or two-month grace period in section 205(d) of the Copyright Act.⁴⁸ If the assignee/debtor does not properly record its newly acquired copyright ownership in a timely fashion, a later assignee from the same assignor prevails if such later assignee records first and takes the assignment "in good faith, for valuable consideration . . . and without notice."⁴⁹

A straight application of the Article Nine priority rules, without taking the derivative title principle into account, could give priority to the secured party. Under current section 9-301(1)(d) or Revised section 9-317(d), it is the secured party, however, who prevails over subsequent transferees or buyers of intangibles if its security interest is attached and

The effect that an underlying defect in the debtor's title to intellectual property can have on the Article Nine priority rules is illustrated in THOMAS M. WARD, *INTELLECTUAL PROPERTY IN COMMERCE* § 2:46 (2000).

⁴⁵ See discussion in PRELIMINARY REPORT #1, *supra* note 9 at Section II(b)(3)(A).

⁴⁶ *Bank of the West v. Commercial Credit Financial Services, Inc.*, 852 F.2d 1162, 6 U.C.C. 2d 602 (9th Cir. 1988) ("We think the correct result is reached in this case by applying the common sense notion that a creditor cannot convey to another more than it owns. Put another way, the transferee, Allied, cannot acquire any greater rights in the beverage business's assets than its transferor, BCI, had in them.") *Id.* at 1174, *citing*, U.C.C. § 2-403(1). See also J. White & R. Summers, *UNIFORM COMMERCIAL CODE* § 24-19(d) at 897-98 (4th ed. 1995).

⁴⁷ 17 U.S.C. § 204 (1994).

⁴⁸ 17 U.S.C. § 205(d) (1994).

⁴⁹ *Id.*

perfected before the subsequent transferee or buyer gives value.⁵⁰ A secured party could argue that it prevails over the subsequent assignee if the security interest is perfected when that subsequent assignee takes from the debtor. The priority rule in Article Nine assumes that both the secured party and the later competing assignee take from a common source debtor.⁵¹ In this example, the priority rule in current section 9-301(1)(d) and Revised section 9-317(d) is trumped by the more general principle of the state law that a secured party can assert no greater rights in the collateral than its debtor. The rights of the copyright assignee displace the rights of the secured party's unrecorded debtor under the federal priority rule in section 205(d) of the Copyright Act. Consequently, the rights of the perfected secured party are displaced under the derivative title predicate to the Article Nine priority rules.⁵²

Similarly, the rights of a subsequent assignee taken from the original assignor without notice, in good faith, and evidenced by a signed writing, prevail over a secured party with a perfected security interest in the general intangibles of an unrecorded assignee/debtor.⁵³ Again, examining only the Article Nine priority rule in section 9-301(1)(d) [Revised section 9-317(d)], the prior perfection of the secured party points to priority as against the subsequent licensee.⁵⁴ However, because the rule in section 9-301(1)(d) assumes that the security interest and the subsequent license have a common source, the derivative title predicate controls. The secured party can have no greater "rights in the collateral" than its debtor.⁵⁵ The subsequent licensee's right to defeat the secured party's unrecorded debtor under section 205(e) of

⁵⁰ U.C.C. § 9-301(1)(d); U.C.C. [Revised] § 9-317(d).

⁵¹ U.C.C. § 2-403(1). See *Bank of the West v. Commercial Credit Financial Services, Inc.*, 852 F.2d 1162, 1174, 6 UCC2d 602 (9th Cir. 1988). See also U.C.C. [Revised] § 9-325, cmt. 6.

⁵² The same principle would hold to give priority to a subsequent secured party who filed second in time but who's debtor displaced the title of the previously filed secured party's debtor. See THOMAS M. WARD, *INTELLECTUAL PROPERTY IN COMMERCE* § 2:46 (2000).

⁵³ 17 U.S.C. § 205(e)(2) (1994). Note that under the decision in *National Peregrine, Inc. v. Capital Federal Savings & Loan Ass'n*, 116 B.R. 194 (C.D. Cal. 1990), a security interest is a "transfer of copyright ownership" within the meaning of sections 101, 201(d) and 205 of the Copyright Act. See discussion *infra* Section III(b)(3)(B). Under *Peregrine*, section 205(e) would also apply *directly* to the priority contest between a secured party and subsequent licensee from the same debtor/licensor. Under section 205(e), a subsequent good faith licensee who takes without notice and under a license evidenced by a signed written instrument prevails over prior secured party of the debtor/licensor's if the secured party has not recorded in the Copyright Office prior to the license. 17 U.S.C. § 205(e)(2) (1994).

⁵⁴ U.C.C. § 9-301(1)(d).

⁵⁵ U.C.C. § 2-403(1).

the Copyright Act also gives it priority over the earlier perfected secured party.⁵⁶

Note, however, that the same license example seems to produce a different answer under the Patent Act because a subsequent innocent licensee does not defeat a prior unrecorded patent assignment.⁵⁷

(b) Debtor's Rights When Ownership Converges

The derivative title principle in Article Nine dictates the debtor "rights in the collateral" when there is a convergence of several different but dependent ownerships in a single intellectual property asset. It may be challenging for a secured party to separate its debtor's "rights" in discrete intellectual property collateral from the related rights of other parties which enhance that debtor's property. This issue of converging interests within the debtor's collateral is discussed in the second opinion of the Bankruptcy Court for the District of New Hampshire in the matter of *C Tek Software, Inc.*⁵⁸

In *C Tek II*, the debtor granted a security interest in its copyrighted software ("ClienTrak") to New York State Business Venture Partnership [NYSBVP] 18 months before the debtor filed for relief under Chapter 11 of the Bankruptcy Code. Nine months before that debtor filed for bankruptcy, it entered into an agreement with Intelligent Investment Systems [IIS] under which IIS acquired exclusive sale and development rights in the copyrighted software for ten years. After the agreement, IIS revised thousands of lines of source code in the software.⁵⁹

In an adversary proceeding to determine the rights of both IIS and NYSBVP in the revised version of the ClienTrak software, IIS conceded that NYSBVP's security interest covered the copyright on the original software.⁶⁰ However, IIS maintained that it, not the debtor or NYSBVP, owned the changes and enhancements it made after entering into the distribution and sales agreement. In response, NYSBVP argued that the language of its

⁵⁶ 17 U.S.C. § 205(e) (1994).

⁵⁷ 6 WALKER ON PATENTS, § 20:28 at 98 (1986).

⁵⁸ 127 B.R. 501 (Bankr. D.N.H. 1991).

⁵⁹ 127 B.R. at 501-02.

⁶⁰ In a prior decision in the same bankruptcy case, the court upheld the perfected status of NYSBVP's security interest, which was perfected under the laws of New York, against challenges from IIS and the debtor in possession. These challenges were based on NYSBVP's failure to refile, or reperfect, its interest after C Tek's hardware moved to Pennsylvania and C Tek's principal relocated in New Hampshire. *In re C Tek Software, Inc.*, 117 B.R. 762 (Bankr. D.N.H. 1990) [hereinafter *C Tek I*].

security agreements covered these improvements as after-acquired property.

The *C Tek II* Court rejected the premise of NYSBVP's argument stating that "the security interest did not attach to modifications made by IIS under . . . § 9-203(1)(c) because . . . the debtor did not have any interest in that collateral."⁶¹ The Court then discussed through the various changes IIS had made to the software. Taken one at a time, these changes could be called minor or cosmetic. When considered collectively, however, the court found these changes sufficiently "original" to qualify for copyright protection as a "derivative work."⁶² As a derivative work, these changes could indeed be the property of IIS, not the property of C Tek.⁶³ Apparently, if these changes in the *ClieTrak* software had not qualified for protection as a "derivative work," IIS would have had no rights in them. In such case, the Court suggested the changes would have to be treated as intangible "accessions" that became part of the debtor's collateral and therefore, part of the prior secured party's interest.⁶⁴

The ownership concepts in section 9-203 are helpful in limiting the metes and bounds of an after-acquired property clause as applied to a copyright. The nature of the intangible right itself, however, makes the application of the after-acquired property clause less critical for the secured party. Unlike tangible accessions that may have stand-alone value after being separated from its hosting "whole,"⁶⁵ a derivative work cannot be "removed" from the base work.⁶⁶ If the owner of the derivative work wants to produce and sell its complete software package it must have a license from the owner of the base work. C Tek did license IIS's development of the software for ten years after it granted a security interest in the copyright to NYSBVP. This exclusive license was a "transfer of copyright ownership."

The question that remains unanswered in *C Tek II* is who has priority as between the conflicting transferees: the party with the prior security interest in the base work or the party granted the the subsequent exclusive license to produce derivative works. The answer in *C Tek, II* regardless of whether the Copyright Act or Article Nine governs priority, seems to be that

⁶¹ 127 B.R. at 502 n.1.

⁶² *Id.* at 506.

⁶³ *Id.* at 507.

⁶⁴ *Id.* 507-08.

⁶⁵ U.C.C. § 9-314(4) & cmt. 2. *Accord* U.C.C. [Revised] § 9-335(e)&(f).

⁶⁶ 17 U.S.C. § 103(a) (1994)("the copyright in a...derivative work extends only to the material contributed by the author of such work, as distinguished from the preexisting material employed in the work, and does not imply any exclusive right in the preexisting material.")

the party with the prior security interest in the base work has priority.⁶⁷ IIS conceded that it knew of the prior security interest when it took its exclusive license from C Tek.⁶⁸ This tainting knowledge provides the basis for the prior secured party's priority under both statutory schemes.⁶⁹ If IIS's license is cut off by the secured party's foreclosure on the base right, IIS wins the battle for separate recognition of its derivative work property under section 9-203, but loses the war. Unlike the owner of a severable accession, IIS will not be able to use its separate copyright in the derivative work without coming to terms with C Tek's prior foreclosing secured party.⁷⁰

⁶⁷ See also *In re National Peregrine Entertainment, Inc.*, 1989 LEXIS 2469 (Bankr. C.D. Cal. 1989), *rev'd*, *National Peregrine, Inc. v. Capital Federal Savings & Loan Ass'n*, 116 B.R. 194 (C.D. Cal. 1990). See also discussion in PRELIMINARY REPORT #1, *supra* note 9 at Section III(b)(3).

⁶⁸ *In re C Tek Software, Inc.*, 117 B.R. 762, 763 (Bankr. D.N.H. 1990).

⁶⁹ The rule in U.C.C. section 9-301(1)(d) requires that a later transferee must give value "without knowledge of the security interest and before it is perfected." U.C.C. § 9-301(1)(d). See U.C.C. [Revised] § 9-317(d) ("licensee" and "buyer" substituted for "transferee"). See discussion in PRELIMINARY REPORT #1, *supra* note 9 at Section II(e)(2)(B)(i). Under section 205(d) of the Copyright Act, the answer is not as clear. However, the last sentence in subsection (d) suggests that the later transfer does not prevail, even if the earlier transfer misses the grace period for recording and thereafter fails to record first, if such later transfer had notice of the earlier transfer. 17 U.S.C. § 205(d) (1994).

⁷⁰ An exclusive license to prepare derivative works that does not have actual knowledge of the security interest in the base work will still lose if the secured party is careful. Perfection of the security interest under Article Nine before the licensee gives value [U.C.C. § 9-301(1)(d)] coupled with filing under the Copyright Act within the grace period or before the licensee files [17 U.S.C. § 205(d)(1994)] will cement the secured party's priority. This result may tend to upset many exclusive licensees with authority to prepare derivative works who make a considerable investment in building value on the base copyright. See J.D. Brinson, *The Copyright Act and Bankruptcy: Perfection, Priorities, and Transfers*, 1 J. OF B.R. LAW & PRAC. 337, 362-63 & n.123 (1992).

[This page left blank]

APPENDIX 12 - U.C.C. ARTICLE NINE: PERFECTION

A. Perfection in Proceeds

Once attached, an Article Nine security interest stays with the collateral when it is sold, exchanged, or otherwise disposed of, unless the secured party expressly or impliedly consents to the “sale or other disposition” free of its interest.¹ When the secured party so consents, the security interest in that collateral is extinguished.² Consent is usually present when the debtor’s collateral is an asset such as inventory or chattel paper that is regularly sold and replaced as part of the debtor’s business activity. Regardless of whether the security interest in the original collateral survives, however, the current language of Article Nine provides that such interest continues “in any identifiable proceeds” of “the sale, exchange, collection, or other disposition”³ The requirement in current Article Nine that “proceeds” arise out of a “sale, exchange, or other disposition” is problematic when intellectual property is exploited or enhanced. In order to alleviate these problems, the “disposition” predicate for “proceeds” has been eliminated from Revised Article Nine.

If collateral subject to a perfected security interest (attachment plus a proper filing) generates proceeds under either version of Article Nine, the original perfection automatically carries over into those proceeds for a short period of time. Under current Article Nine, this automatic perfection lasts for ten (10) days.⁴ Under Revised Article Nine the period of automatic perfection is twenty (20) days.⁵ Perfection in the proceeds will continue beyond the interim automatic period without a new filing covering the proceeds if: (1) the proceeds are identifiable cash proceeds, or (2) the proceeds are collateral in which a security interest “may be perfected by filing in the office or offices where the financing statement has been filed”

¹ U.C.C. § 9-306(2). *See also* U.C.C. [Revised] § 9-315(a)(1)(The Revision language expands the existing reference to “sale, exchange, or other disposition” in present section 9-306(2) to include a “lease” and “license” by the debtor.)

² *Id.*

³ *Id.*

⁴ U.C.C. § 9-306(3).

⁵ U.C.C. [Revised] § 9-315(c)(d)&(e). Curiously, unlike the current rule in section 9-306(3) the Revisions provide no continuous perfection for second generation proceeds, acquired with first generation cash proceeds, even where the original financing statement contains a type indication that covers the second generation proceeds.

that “covers” the original collateral.⁶ Under current Article Nine, the income stream from an assignment or other complete and permanent disposition of an underlying intellectual property right would normally be viewed as a general intangible, or in some cases an account.⁷ Under Revised Article Nine this income stream would always be an account.⁸ As long as an existing filing “covering” the original collateral exists in the appropriate office for perfecting interests in newly generated accounts or general intangibles, perfection in such proceeds should be continuous. Note that the existing filing that “covers” the original collateral need not perfect the original collateral. For example, a financing statement that “covers” federal copyright collateral and is filed within the appropriate state’s central file should be effective to continue state law perfection in the income stream “proceeds” even if the proper “state law” place to perfect the original copyright collateral, under the “step-back” filing rule in section 9-302(3)(a), is the Copyright Office.⁹ Finally on the issue of priority, Article Nine provides that whenever the order of perfection controls priority between conflicting interests, perfection in the original collateral is also the date of

⁶ U.C.C. § 9-306(3)(a). Accord U.C.C. [Revised] § 9-315(c)(1)(B). Under the current language, if second generation proceeds are acquired with “cash proceeds” from the original collateral, perfection can be continuous if the original financing statement indicates “by type” the property constituting the second generation proceeds. *Id.* This continuous protection for second generation proceeds that fall within the collateral types in the financing statement was not carried over into the language of Revised Article Nine.

⁷ U.C.C. § 9-106. See discussion PRELIMINARY REPORT #1: AN OVERVIEW OF THE CURRENT LEGAL RULES AND STRUCTURES GOVERNING THE PERFECTION AND PRIORITY OF SECURITY INTERESTS IN INTELLECTUAL PROPERTY AND AN ANALYSIS OF PROPOSED LEGISLATIVE REFORMS Section II (a)(1)(C) (Cooperative Contract - U.S.P.T.O. and Franklin Pierce Law Center 2000).

⁸ Income streams from licensing are “accounts” under the definition in Revised Article Nine. U.C.C. [Revised] § 9-102(a)(2). See discussion in PRELIMINARY REPORT #1, *supra* note 7 at Section II(a)(1)(D).

⁹ U.C.C. § 9-302(3)(a),(4) & cmt. 8. If proceeds in the form of receivables generated by the licensing of copyright collateral must also be recorded in the Copyright Office under step-back in section 9-302(3)(a), then this recording of the full security agreement document covering the original collateral under section 205(a) of the Copyright Act should be viewed as the equivalent of filing a financing statement that “covers the original collateral” under section 9-306(3)(a). This equivalence is made clear with respect to the new filing “step-back” rule in section 9-311(a)(1) of Revised Article Nine. U.C.C. [Revised] § 9-311(a)(1). Comment 6 to Revised section 9-315 expressly provides that “compliance with the perfection requirements of a statute or treaty described in Section 9-311(a)” is the equivalent of the filing of a financing statement that covers the original collateral within the meaning of the continuous perfection rule. U.C.C. [Revised] § 9-315, cmt. 6.

continuing perfection as to the proceeds.¹⁰

1. Disposition Requirement

a) Disposition of Original Collateral

The advantages of carried-over perfection are only available if new property that comes to the debtor through or out of the original collateral is, in fact, "proceeds." "Proceeds" arise, under the language of current section 9-306(1), only from a "sale, exchange, collection, or other disposition" of the collateral.¹¹ Whenever the debtor sells collateral for money or exchanges it for other property, the required "disposition" is clearly present. Although the extent of disposition required is not clear, there is authority for the position that even a partial disposition of collateral will generate proceeds. In its Commentary No. 9, the Permanent Editorial Board of the Uniform Commercial Code concluded that even when the debtor *leases* goods for a short period of time, a "disposition occurs and the resulting account or chattel paper is "proceeds."¹² The Board's Commentary interprets the word "disposition" in current section 9-306(1) to include even a short term lease of goods, on the theory that the debtor/lessor parts with some portion of the debtor's property.¹³ It must be noted, however, that the conclusion of PEB Commentary No. 9 runs counter to a number of earlier cases holding that *only a complete or permanent* disposition was capable of generating proceeds.¹⁴ While Commentary No. 9 rejects this requirement of a complete or permanent disposition, it does not "address other transactions (those involving the licensing of intangibles in particular) where *no* disposition . . . has taken place."¹⁵

¹⁰ U.C.C. § 9-306(3)(a) & 9-312(6).

¹¹ U.C.C. § 9-306(1).

¹² *PEB Commentary No. 9*, [PEB Commentaries] U.C.C. Rep. Serv. 3 (Clark Boardman Callaghan) (June 25, 1992). The commentary relies on the common law rule that the granting of a real estate leasehold interest constitutes a disposition of a *portion* of the lessor's ownership interest in the leased estate. See, e.g., *Hueschen v. Stalie*, 98 N.M. 696, 652 P.2d 246 (1982); Powell, *LAW OF REAL PROPERTY* § 221 (1990).

¹³ *Id.*

¹⁴ *In re Northview Corp.*, 130 B.R. 543, 548, 15 U.C.C. 1041, 1047-48 (9th Cir. BAP 1991); *In re S & J Holding Corp.*, 39 UCC 668, 669 (Bankr. S.D. Fla. 1984); *In re A.E.I. Corp.*, 11 B.R. 97,102, 31 UCC 1467, 1469-70 (Bankr. E.D. Pa. 1981); *In re Cleary Bros. Construction Co.*, 9 B.R. 40, 30 UCC 1444, 1445 (S.D. Fla. 1980).

¹⁵ *PEB Commentary No. 9*, *supra* note 12. The need for even a partial disposition of some

Revised Article Nine addresses this licensing question by moving sharply away from the “disposition” predicate for “proceeds.” The 1992 Report of the PEB Study Group on Article Nine suggested that exchange *and replacement* of the original collateral under section 9-306(1) should be viewed as a singular idea.¹⁶ Under a test that looks at a resulting income stream as a *substitution* for value lost in the original collateral, rather than on the *exchange* of all or part of the res, royalties arising from the debtor's nonexclusive licenses should qualify as proceeds.¹⁷ The Report of the Study Group called for a revision of the “proceeds” concept that would either broaden the definition of “disposition” or replace the definition with a concept closer to substitution, in order to include royalties from the debtor's licensing activities.”¹⁸

In response to the charge of the Study Group, section 9-102(a)(64)(A) of Revised Article Nine defines “proceeds” to expressly include “whatever is acquired upon the sale, lease, *license*, exchange, or other disposition of collateral.”¹⁹ The language seems to include whatever the debtor acquires in exchange when any type of license of intellectual property is created. That conclusion is not absolutely clear because the concluding phrase of subsection (a)(64)(A), “or other disposition of collateral,” might be interpreted as a limitation on the prior enumerated forms, in the sense that all activity listed must be some form of traditional “disposition.” If so construed, subsection (a)(64)(A) in the Revised Article Nine definition might still fall under the shadow of the existing rule, making only licenses of intellectual property that disposed of all or some part of the underlying *res* capable of generating proceeds. However, “other disposition” in the Revision need not reflect on the preceding enumerated means for proceeds generation. Including all licenses of intellectual property within the operation of the phrase “acquired upon the . . . license” is certainly more in line with the recommendations of the Study Group.²⁰ Furthermore, even if the revised language in section 9-102(a)(64)(A) refers only to licenses that

property “res” has been abandoned in Revised Article Nine. Revised Article Nine defines proceeds to include “(1) whatever is acquired upon the “sale, lease, license, exchange, or other disposition of collateral; (2) whatever is *collected on*, or *distributed on account* of collateral; and, (3) rights *arising out of* collateral...” U.C.C. [Revised] § 9-102(a)(64)(A),(B)&(C)(Emphasis added).

¹⁶ PEB Study Group on Uniform Commercial Code Article Nine, *Report* 106 & 110 (December 1, 1992).

¹⁷ *Id.* at 110.

¹⁸ *Id.* at 26, 106 & 110.

¹⁹ U.C.C. [Revised] § 9-102(a)(64).

²⁰ *See supra* note 16.

“dispose” of all or part of the underlying property, subsection (a)(64)(B) further defines as proceeds “whatever is collected on collateral.”²¹ Income received on a license that created no more than a personal right in the licensee would arguably fall within the “collected on” language in Revised section 9-102(a)(64)(B).

While Revised Article Nine expands the definition of proceeds so as to include nearly all contractual exploitations of intellectual property, the disposition predicate in current section 9-306 forces consideration of two serious “proceeds” issues related to intellectual property collateral. First, it is not clear under the current language of section 9-306(1) whether or to what extent a security interest in a specific form of the debtor’s intellectual property will carry over as “proceeds” into a new enhanced form that was derived from the original intangible collateral. The broad definition of “proceeds” in the Revisions seems to embrace the notion of evolving collateral rights. Second, as mentioned above, the current disposition predicate seems to limit income stream “proceeds” of intellectual property collateral to those generated by licensing that entails some “disposing” of the debtor’s underlying intellectual property *res*. While the Revised “proceeds” definition seems to solve the licensing income problem, current law forces a close examination of the property rules surrounding the debtor’s licensing activity.

b) Disposition of a Maturing Right

From the debtor’s conception of a single innovation, a trade secret, a patent application, or an issued patent may finally evolve. The authors have examined the argument that a debtor/owner might obtain sufficient section 9-203 “rights” in some mature form of intellectual property, thus allowing a security interest to “attach” to that mature form, from the moment it was conceived of or had existence in some unmatured, unprotected or differently protected form.²² As was suggested in that earlier discussion, the intellectual property lawyer and the commercial lawyer would be well advised to view each stage of protection as a separate and discrete form of property capable of providing the secured party with attached rights only when each stage is actually reached.²³ Beyond this “inchoate attachment” argument, it is possible to argue that when each separate form of intellectual property right yields to the next form a section 9-306(1) “disposition” of the prior collateral

²¹ U.C.C. [Revised] § 9-102(a)(64)(B).

²² See discussion in PRELIMINARY REPORT #1, *supra* note 7 at Section II(b)(3)(B).

²³ *Id.*

form has occurred.²⁴ Thus, while a debtor may not actually be able to acquire “rights” in a patent application until the application is filed, that same patent application once filed, could be viewed as the “proceeds” of an earlier trade secret. [Remember that the perfection (including the date of perfection) can carry over from the original collateral into the proceeds.²⁵] Similarly, the subsequently issued patent could be viewed as the “proceeds” of its patent application and the second generation proceeds of the earlier trade secret.

This argument that a “disposition” of collateral under current section 9-306(1) embraces the concept of maturing transmutation was rejected by the Bankruptcy Court in the *Matter of Transportation Design and Technology, Inc.*²⁶ *Transportation Design* held that a patent is not the “proceeds” of a patent application because the issuance of the patent is not a “disposition” of the application within the meaning of section 9-306(1). Despite the circular reasoning, the Court seems to limit “disposed of” to acts of final and permanent disposition analogous to a sale.²⁷ Under *Transportation Design*, even though a trade secret is lost when a patent issues,²⁸ it is not “disposed of” in a section 9-306(1) exchange or other disposition.

Transportation Design has been criticized for narrowly interpreting the “disposition” requirement in current section 9-306(1). Defending their comprehensive proposal for a “Federal Article Nine Text” covering federal intellectual property, Professors Weinberg and Woodward argue that secured parties using intellectual property as collateral may need protection against the “risk of surprise metamorphosis.”²⁹ They suggest that *Transportation Design* may not be the best interpretation of the current text of section 9-306(1). If the protection of state trade secret law is “exchanged” for federal patent protection, they argue, then the patent *can* be viewed as section 9-306(1) “proceeds.”³⁰ Weinberg and Woodward ultimately recede from this suggested argument, however, because “trade secrets are quantitatively different from patents.”³¹ They conclude that under the current Article Nine language the underlying innovation gets new vestments when a patent issues

²⁴ See the discussion in Weinberg & Woodward, *Easing Transfers, and Security Interest Transactions in Intellectual Property: An Agenda For Reform*, 79 KY. L.J. 61, 120-121 (1991).

²⁵ See discussion in PRELIMINARY REPORT #1, *supra* note 7 at Section II(c)(1).

²⁶ 48 B.R. 635, 640, 40 UCC 1393, 1399-1400 (Bankr. S.D. Cal. 1985).

²⁷ In the case of goods, the Commercial Code defines “sale” as “the passing of title from the seller to the buyer for a price.” U.C.C. § 2-106(1).

²⁸ *Kewanee Oil Co. v. Bicron Corp.*, 416 U.S. 470 (1974).

²⁹ Weinberg & Woodward, *Easing Transfers*, *supra* note 24 at 121.

³⁰ *Id.* at 117.

³¹ *Id.* at 118.

and that these vestments are more than just an exchanged substitute for the old trade secret cloth. While acknowledging this limitation in the current Article Nine text, Weinberg and Woodward remain convinced that a secured party *should* be able to trace a collateral right in a single innovation through its different vestments. To that end, they urged the expansion of the "proceeds" concept as set forth in current section 9-306(1) "to cover new developments."³²

The definition of "proceeds" in the Revisions moves sharply in the direction favored by Professors Weinberg and Woodward, and well beyond any notions of replacement value. "Disposition" is no longer the centerpiece of the proceeds definition under the Revisions. Revision section 9-102(a)(64) defines "proceeds" to include "whatever is collected on . . . collateral, as well as "rights arising out of collateral." Profits and other enhancing *derivatives* from collateral seem to be included within this definition.

c) Disposition of a License

The language of *Transportation Design* suggested that a license of intellectual property that was not, in substance, an assignment or outright transfer of ownership could not yield "proceeds" because the underlying disposition of the intellectual property by the licensor/debtor would not be final and permanent. While the result suggested by *Transportation Design* may be appropriate under those specific facts, the Court's reasoning overstates the "disposition" requirement because, as already noted, even a *partial* disposition may satisfy current section 9-306(1).³³ Although there is conflict in the case law dealing with tangible property,³⁴ PEB Commentary

³² *Id.* at 118 & 121.

³³ *In re Northview Corp.*, 130 B.R. 543, 548, 15 U.C.C. 1041, 1047-48 (9th Cir. BAP 1991); *In re S & J Holding Corp.*, 39 UCC 668, 669 (Bankr. S.D. Fla. 1984); *In re A.E.I. Corp.*, 11 B.R. 97,102, 31 UCC 1467, 1469-70 (Bankr. E.D. Pa. 1981); *In re Cleary Bros. Construction Co.*, 9 B.R. 40, 30 UCC 1444, 1445 (S.D. Fla. 1980). Not all Courts have been rigorous about the section 9-306(1) "disposition" requirement. *In re Dettman*, 84 B.R. 662, 665 (B.A.P. 9th Cir. 1988)(crop diversion certificates were "substitutes" for grapes that were the product of vines that were pre-petition collateral). *But see In re Northview Corp.*, 130 B.R. 543, 548, 15 UCC 1041, 1047-48 (B.A.P. 9th Cir. 1991)(rental income not proceeds).

³⁴ Compare PEB Commentary No. 9, *supra* note 12 with; *In re S & J Holding Corp.*, 42 Bankr. 249, 250 (Bankr. S.D. Fla. 1984)(income generated from use of video machines is not proceeds under section 9-306(1)); *In re A.E.I. Corp.*, 11 B.R. 97, 102, 31 UCC 1467, 1469-70 (Bankr. E.D. Pa. 1981); *In re Cleary Bros. Construction Co.*, 9 B.R. 40, 30 UCC 1444, 1445 (S.D. Fla. 1980)(security interest in equipment does not include lease proceeds from rental of equipment unless the lease itself is also collateral).

No. 9 on section 9-306(1) concludes that a *partial* disposition of the owner/debtor's underlying property right in goods should be enough of a "disposition" to generate proceeds.³⁵

If a license transfers *some part* of the licensor's underlying right, then a license of intellectual property would seem capable of generating proceeds to the same extent as a lease of tangible property. Underlying federal intellectual property law distinguishes a partial transfer of the underlying intangible *res* from a mere personal right to use that *res*. However, this underlying law is not always understood or correctly applied within the appropriate state commercial statute.³⁶

Almost infinite divisibility of the underlying *intangible* right is a characteristic of copyright law.³⁷ A copyrighted work is capable of being divided into segments, each capable of separate ownership.³⁸ An exclusive license of a copyright is a "transfer of copyright ownership" under the Copyright Act.³⁹ Therefore, the complete and permanent transfer of such an ownership segment, as distinguished from a personal right to make limited nonexclusive use of the copyright (a nonexclusive license), should generate "proceeds" under the test suggested by the Permanent Editorial Board in its Commentary No. 9.⁴⁰ For example, the transfer of *exclusive* movie rights under a copyright can generate "proceeds" because the copyright owner has not just provided the transferee with immunity from suit but has made a complete and permanent disposition of a *part* of the copyright.⁴¹

In the case of a patent or trademark, however, a license is usually just a contractual promise of immunity from an infringement suit. Even an exclusive patent license does not convey an interest in the patent unless it has the legal effect of an assignment.⁴² The exclusive patent license has that legal

³⁵ PEB Commentary No. 9, *supra* note 12.

³⁶ See, e.g., *In re Quintex Entertainment, Inc.*, 950 F.2d 1492, 1498 (9th Cir. 1991) This distinction becomes even more critical in bankruptcy.

³⁷ Section 106 of the Copyright Act confers on the holder of a copyright a bundle of separate and distinct exclusive rights. 17 U.S.C. § 106 (1988). The *grant* of one exclusive right does not impair any of the other exclusive rights retained. See *Columbia Pictures Industries v. Redd Home*, 749 F.2d 154, 158 (3d Cir. 1984).

³⁸ Compare: *Moore v. Marsh*, 74 U.S. 515 (1869) and *Merck & Co. v. Smith*, 155 F. Supp. 843 (E.D. Pa.), *aff'd* 261 F.2d 162 (3d Cir. 1957) with *Shutes v. Cheney*, 123 Cal App. 2d 256, 266 P.2d 902, 101 U.S.P.Q. 90 (1954). See also *In re Simplified Information Systems, Inc.*, 89 B.R. 538, 541 (W.D. Pa. 1988).

³⁹ 17 U.S.C. § 101 (1994).

⁴⁰ PEB Commentary No. 9, *supra* note 12.

⁴¹ *Columbia Pictures Industries v. Redd Home*, 749 F.2d 154, 158 (3d Cir. 1984).

⁴² *Waterman v. Mackenzie*, 138 U.S. 252 (1891). See also 6 WALKER ON PATENTS, § 20:3, (1986).

effect only when it is a grant of the "exclusive right to *make, use, and vend* the invention throughout the United States, or in a specified part thereof, or of any undivided part or share of that exclusive right."⁴³

Under current Article Nine language, the income stream from a "license" would seem to be proceeds when the "license" transfers all or some divisible part of the intellectual property.⁴⁴ Most exclusive licenses and all nonexclusive licenses are transfers of a much more limited nature, however. The right conveyed to the licensee is more akin to a personal contract right than a disposition of even a part of the underlying *res*.⁴⁵ The license protects the licensee from a suit for infringement as long as use does not exceed the contractual authorization.⁴⁶ Such a license would not normally carry with it any right that can be separated from the licensor's underlying *res*.⁴⁷

In concluding that a *disposition* of goods by "security lease"⁴⁸ or "true lease"⁴⁹ creates section 9-306 proceeds, the Permanent Editorial Board in its Commentary No. 9 distinguished the transfer of a partial property interest from the case where only a personal "right to use" was transferred.⁵⁰ Under the theory of Commentary No. 9, if there is no disposition of the *goods*, there can be no proceeds. Even though a pure lease of goods results in a section 9-306 disposition, most licenses do not qualify as a section 9-306 disposition because they leave the licensor's *res* undisturbed.

While the concept of transferred ownership might suggest a basis for

⁴³ 5 WALKER ON PATENTS, § 19:12 at 367 (1986).. A nominal exclusive license may have the effect of a grant. *See* Control Components, Inc. v. Atlantic Richfield Co., 439 F. Supp. 654, 655, 200 U.S.P.Q. 334, 334-35 (C.D. Cal. 1977). *See also* Moore v. Marsh, 74 U.S. 515 (1869); Merck & Co. v. Smith, 155 F. Supp. 843 (E.D. Pa.), *aff'd* 261 F.2d 162 (3d Cir. 1957).

⁴⁴ *See* Merck & Co. v. Smith, 155 F. Supp. 843 (E.D. Pa.), *aff'd* 261 F.2d 162 (3d Cir. 1957).

⁴⁵ *In re Alltech Plastics, Inc.*, 71 B.R. 686, 689 (W.D. Tenn. 1987). *See* Weinberg and Woodward, *Easing Transfers*, *supra* note 24 at 114.

⁴⁶ *Spindelfabrik Suessen-Schurr, Stahlecker & Grill GmbH v. Schubert & Salzer Maschinenfabrik Aktiengesellschaft*, 829 F.2d 1075, 1081 (Fed. Cir. 1987).

⁴⁷ *Id.* at 1081; *Public Varieties of Mississippi, Inc. v. Sun Valley Seed Co., Inc.*, 734 F. Supp. 250 (N.D. Miss. 1990); *BGT Enterprises, Inc. v. Gronholz*, 406 N.W.2d 321, 323 (Minn. App. 1987); *Harris v. Emus*, 734 F.2d 1329, 222 U.S.P.Q. 466, 1984 Copyright Dec. 449, 453 (9th Cir. 1984).

⁴⁸ U.C.C. § 1-201(37) & § 9-102(1)(a).

⁴⁹ U.C.C. § 2A-102 & § 2A-103(1)(j).

⁵⁰ PEB Commentary No. 9., *supra* note 12. *See also In re S & J Holding Corp.*, 42 B.R. 249, 39 UCC 668 (Bankr. S.D. Fla. 1984). *But see In re Dettman*, 84 B.R. 662, 665 (9th Cir. B.A.P. 1988)(crop diversion certificates were "substitutes" for grapes that were the product of vines that were pre-petition collateral).

excluding the earnings generated from nonexclusive licenses and many exclusive patent licenses from section 9-306(1), there is an argument for reading "disposition" more expansively when intellectual property is the underlying *res*. The intellectual property which is *disposed of* might be no more than a personal right in the hands of the debtor/transferor. Even when a license is defined as a personal right which is not transferable without the licensor's consent, it seems capable of supporting a security interest in the first instance.⁵¹ If the complete disposition of such an *existing* personal right generates proceeds, creation of the personal right in the first instance ought to be a proceeds-generating act as well.

The new proceeds definition in Revised Article Nine should bring all licensing income under the "proceeds" definition. As the discussion in Section II(c)(2)(A) explains,⁵² income, even from a nontransferable nonexclusive license should be "proceeds" under the new language in section 9-102(a)(64).⁵³ It should apply either under the language of subsection (64)(A) that expressly refers to "whatever is acquired upon the . . . license . . . of collateral"⁵⁴ or under the language of subsection (64)(B) that includes "whatever is collected on . . . collateral."⁵⁵

This new "proceeds" definition in the Revisions should also relieve a problem that arises in connection with the mass-market licensing of software and contemporaneous delivery of its embodiment.⁵⁶ With software, there is an apparent unity of interest and right. The *tangible* physical property embodies the intangible property. The tangible property is also necessary for the effective use of the intangible property.⁵⁷ Software licenses are typified

⁵¹ *In re Thomas Communications, Inc.*, 161 B.R. 621, 624-26 (Bankr. S.D. W.Va. 1993). The question of whether a security interest can be carved out of a governmental license that prohibits assignment without consent is still an open issue. Compare: *In re Ridgely Communications, Inc.*, 139 B.R. 374 (Bankr. D. Md. 1992) with *In re Tak Communications, Inc.*, 138 B.R. 568 (W.D. Wis. 1992), *aff'd* 985 F.2d 916 (7th Cir. 1993). See also PEB Study Group on Uniform Commercial Code Article Nine, Report 178 (December 1, 1992).

⁵² See discussion in PRELIMINARY REPORT #1, *supra* note 7 at Section II(c)(2)(A) in text accompanying notes 201 to 206.

⁵³ U.C.C. [Revised] § 9-102(a)(64).

⁵⁴ U.C.C. [Revised] § 9-102(a)(64)(A).

⁵⁵ U.C.C. [Revised] § 9-102(a)(64)(B).

⁵⁶ *In re Bedford Computer Corp.*, 62 B.R. 555, 567 (Bankr. D.N.H. 1986); *In re C Tek Software, Inc.*, 117 B.R. 762, 763 (Bankr. D.N.H. 1990). Other cases holding that software products are "goods" include: *Step-Saver Data Systems, Inc. v. Wyse Technology*, 939 F.2d 91 (3d Cir. 1991); *Advent Systems Ltd v. Unisys Corp.*, 925 F.2d 670 (3d Cir. 1991); *RRX Industries, Inc. v. Lab-Con, Inc.*, 772 F.2d 543 (5th Cir. 1985); *Triangle Underwriters, Inc. v. Honeywell*, 604 F.2d 737 (2d Cir. 1979).

⁵⁷ So-called "commercial licenses" usually involve software imbedded in a disk or other

by a characteristic, which marks intellectual property transactions as *dispositions of property*. The intellectual property license is enhanced by and embodied in physical property, which is generally delivered with the license. With respect to this delivered physical embodiment some "disposition" clearly occurs. According to some authority, such a disposition cannot be prevented, even when the debtor/licensor employs language in the licensing agreement reserving title to the embodiment.⁵⁸ If such a reservation is simply to secure a payment or the performance of license terms by the licensee, it should be limited in effect to a security interest.⁵⁹ If the licensor is deemed to reserve a security interest only, the title to the embodiment passes to the licensee despite the title reservation language.⁶⁰ Even if the circumstance of the license suggests that such language should be given effect as a lease of the underlying embodiment,⁶¹ the resulting leasehold interest that passes to the licensee would be a sufficient "disposition."⁶² However, unless the license transferred some part of the underlying

medium. These licenses may also involve the transfer of access codes and manuals which make the software usable.

⁵⁸ See, e.g., Microsoft Software License Card, Microsoft Flight Simulator for MS-Dos Version 5.00 para.#4 (1993).

⁵⁹ U.C.C. § 401(1) & § 1-207(37).

⁶⁰ *Id.*

⁶¹ Whether title to the delivered embodiment can properly be reserved in the licensee requires consideration of the entire transfer agreement and the type of market in which the license is used. A title reservation by a commercial licensor who is paid in installments and fairly expects return of the physical "copy" should be treated like a lease. See Draft U.C.C. § 2B-501, Reporter's Note 3 (Discussion Draft, August 1, 1998). On the other hand, the nature of single payment consumer transactions suggest that the licensee has an unlimited right to possess the underlying embodiment or "copy." R. NIMMER, THE LAW OF COMPUTER TECHNOLOGY § 1.18[1] (1992). Most of the cases on the ownership of a "copy" arise under section 117 of the Copyright Act. Only the "owner of a copy of a computer program" has section 117 rights to make a copy or adaptation that would otherwise infringe. 17 U.S.C. § 117 (1994). See *Applied Information Management, Inc. v. Icart*, 976 F. Supp. 149, 154-55 (E.D.N.Y. 1997) (Commercial license with three separate payment periods creates a genuine issue of material fact as to ownership of the delivered copy.); *DSC Communications Corp. v. Pulse Communications, Inc.*, 976 F. Supp. 359, 362-63, rehearing denied, 1997 LEXIS 10093 (E.D. Va. 1997) (Commercial license with single payment makes the transaction a sale of the copy.) Section 2B-501A(a)&(b) of the proposed Uniform Computer Information Transactions Act [formerly proposed Article 2B of the U.C.C.] would allow the location of title to copies to be determined by the "agreement." Draft U.C.I.T.A. § 2B-501A(a)&(b) (Draft, February 1, 1999). "Agreement" is defined broadly in U.C.C. section 1-201(3) to include course of dealing and usage of trade. U.C.C. § 1-201 & § 1-205.

⁶² See discussion in PRELIMINARY REPORT #1, *supra* note 7 at Section II(c)(2)(A).

intellectual property [not the case with a nonexclusive license], there is no section 9-306(1) “*disposition*” of that intangible property sufficient to render the return income to the licensor/debtor “proceeds.”⁶³ Rather than focus on the subtle dual nature of most pre-assembled software packages, some Courts have tended to place the whole transfer transaction in one exclusive category depending, to some extent, on the degree to which the transfer resembles the sale of a “goods” *product*.⁶⁴ The “proceeds” issue for the secured party should be whether the underlying intellectual property collateral has been disposed of by the debtor. The Court may treat the total sale and license transaction like a sale of a product or a sale of goods. In this case the secured party which has an interest in the debtor/licensor’s “goods” (broadly defined) arguably has a better “proceeds” claim to the income stream from the license than the party with a security interest which is limited to the underlying intellectual property that was retained.

Because software might mistakenly be classified as “goods” under current Article Nine,⁶⁵ the commercial software financier should not limit its security interest to the debtor’s general intangibles and simply rely on the proceeds right in section 9-306 to hold the resulting income stream. Even a clause covering after-acquired intangibles might not pick up this income stream if the Court decides that the unitary commercial license should be treated as a sale of goods.⁶⁶ In that case, the resulting income stream would be classified as an “account,”⁶⁷ thus making the intellectual property financier’s priority over any existing accounts financier critical.⁶⁸

As noted earlier in Section II(a)(1)(D), Revised Article Nine expands the definition of an “account” to include “a right to payment of a monetary obligation...for property that has been sold, leased, licensed, assigned, or otherwise disposed of”⁶⁹ Because royalties owed to the debtor on

⁶³ A typical shrinkwrap term in a commercial software license provides that the buyer has not purchased the software itself but has merely obtained a personal nontransferable right to use the program. *See, e.g., Arizona Retail Systems, Inc. v. Software Link, Inc.*, 831 F. Supp. 759 (D. Ariz. 1993).

⁶⁴ *Id.* *See* Nimmer, *The Uniform Commercial Code Proposed Article 2B Symposium: Article 2B: An Introduction*, 17 J. MARSHALL J. COMPUTER & INFO. L. 211, 213-215 (1997)(software as “goods” cases.).

⁶⁵ *See* cases cited *supra* at note 56.

⁶⁶ “Software” is defined as a “general intangible” under the Article Nine Revisions, however. U.C.C. [Revised] § 9-102(a)(42).

⁶⁷ U.C.C. § 9-106.

⁶⁸ The first-to-file on either the debtor’s goods or the debtor’s accounts would have priority in the proceeds generated by the sale of the debtor’s goods. U.C.C. § 9-312(5) & Official Comment 8. *See also* U.C.C. [Revised] § 9-317(a)(1) & § 9-322(a).

⁶⁹ U.C.C. [Revised] § 9-102(a)(2). The present definition of account includes only those

intellectual property collateral are treated as "accounts" under Revised Article Nine, parties lending on the strength of the debtor's intellectual property collateral will have to be wary of account financiers even if the licensing of their intellectual property cannot be treated as a disposition of goods. Under the Revisions, anyone financing the debtor's intellectual property will have to file his or her security interest ahead of the debtor's account in order to claim priority in royalties received from the licensing of covered intellectual property.⁷⁰

Finally, the expanded definition in Revised Article Nine also changes the proceeds rules as applied to cross-licensing agreements. Under the current disposition of ownership test, most cross-licensing agreements would not yield "proceeds" under section 9-306 unless the debtor/licensor parts with some transferable *property interest* in the original intellectual property collateral in order to acquire the other party's right to use.⁷¹ The substitution of value test captured in section 9-102(a)(64) of the Revisions will treat all license rights received by the debtor in exchange for rights to use the debtor's own intellectual property collateral as "proceeds" of that collateral.⁷²

rights to payment generated by the sale or lease of goods or the rendering of a service. U.C.C. § 9-106.

⁷⁰ U.C.C. [Revised] § 9-319(a)(1)&(b)(1).

⁷¹ Current section 9-306 does require that the proceeds themselves be a disposition of property by the other party. Proceeds includes "whatever is received." As long as the debtor parts with a transferable *property interest* in the original intellectual property collateral in order to acquire a right to use from the other licensor, the right to use under the license received are "proceeds" of the debtor's original intellectual property collateral. U.C.C. § 9-306(1).

⁷² U.C.C. [Revised] § 9-102(a)(64). See also Superseded Draft U.C.C., Article Nine Revisions - Reporters' Prefatory Comments at 5(f) (Proposed Final Draft, April 15, 1998).

APPENDIX 13 - LOCATION RULES FOR GENERAL INTANGIBLES

When the debtor's intellectual property collateral is defined as "general intangibles," the proper place to file for perfection under current Article Nine is "the jurisdiction in which the debtor is located" The current location rules require some analysis of the debtor's operation and manner of doing business. Under section 9-103(3)(d), the debtor is "deemed located at his place of business if he has one, at his 'chief executive office' if he has more than one place of business, otherwise at his residence."² If the debtor has only one location at which business with the public is conducted however, the debtor lives and conducts financial affairs of the business from a home office in a different state, it would be prudent to file the security interest in the general intangibles in both states. If the home office is not considered a "place of business," and the debtor has only one "place of business" (the state in which the public operations take place) the location of that business is the proper place to file a security interest in general intangibles. If the home office is also considered a "place of business," it will probably be considered the "chief executive office." The "chief executive office" is the executive headquarters for the debtor's multi-state operation, not necessarily the location which generates the largest business volume.³ If the debtor clearly has more than one "place of business," it would be prudent to file in all of those states which could be considered the "chief executive office."⁴ If the debtor has ceased operations and has no place of business, the debtor's residence is the proper location.⁵

¹ U.C.C. § 9-103(3)(b).

² U.C.C. § 9-103(3)(d). *But see* U.C.C. [Revised] § 9-307. Under the "location" rules in Revised Article Nine, a "registered organization," such as a corporation, is located in the state under whose laws it is organized. In the case of a corporation this is the state of incorporation. U.C.C. [Revised] § 9-307(e). An "individual debtor" is located at his or her principal residence. U.C.C. [Revised] § 9-307(b)(1). A business debtor that is not an individual or a registered organization is located at its "place of business" if it has only one such place, and at its "chief executive office" if it has more than one such place. U.C.C. [Revised] § 9-307(b)(2)&(3).

³ U.C.C. § 9-103, Official Comment 5(c). *See* J.A. Thompson & Sons, Inc. v. Sheperd Machinery Co., 665 F.2d 941, 949-50 (9th Cir. 1982); *In re* Golf Course Builders Leasing, Inc., 768 F.2d 1167, 1169-70 (10th Cir. 1985).

⁴ U.C.C. § 9-103, Official Comment 5(c). *See* National Peregrine, Inc. v. Capital Federal Savings & Loan Ass'n., 116 B.R. 194, 198 (C.D. Cal. 1990) (The collateral consisted of the debtor's library of copyright protected films. The secured party filed in Colorado, California and Utah in an effort to make sure that it hit the debtor's location. Unfortunately, the secured party did not record in the Copyright Office).

⁵ U.C.C. § 9-103. *Cf. In re* C Tek Software, Inc., 117 B.R. 763, 770-71 (Bankr. D.N.H.

Under the “location” rules of Revised Article Nine, a “registered organization,” such as a corporation, is located in the state under whose laws it is organized. In the case of a corporation this is the state of incorporation.⁶ An “individual debtor” is located at his or her principal residence.⁷ A business debtor that is not an individual or a registered organization is located at its “place of business” if it has only one such place, and at its “chief executive office” if it has more than one such place.⁸ Location issues are still of concern to secured parties, however, because those who own rights in collateral often change their location. This change can occur when the debtor’s corporate structure changes (e.g., by merger) even if nothing tangible moves. When the debtor who holds intellectual property collateral changes location, perfection continues for either four months or one year, depending on the nature and circumstances of the change.⁹ However, the secured party must file in the new location must occur before the old perfection expires under the law of the old location or before the grace period expires, whichever is earlier.¹⁰ If a new timely filing is not made in the new location, perfection in the intellectual property is lost.¹¹

1990). *But see* U.C.C. [Revised] § 9-307(g)(location of registered organization in state of organization continues after dissolution).

⁶ U.C.C. [Revised] § 9-307(e).

⁷ U.C.C. [Revised] § 9-307(b)(1).

⁸ U.C.C. [Revised] § 9-307(b)(2)&(3).

⁹ U.C.C. [Revised] § 9-316(a)(2)&(3)& cmt. 2, Examples 1 and Example 4. *See also* U.C.C. [Revised] § 9-508(b).

¹⁰ U.C.C. [Revised] § 9-316(g).

¹¹ *Id.*

APPENDIX 14 - APPLICATION OF PRIORITY RULES

1. Secured Party vs. Lien Creditor

Under current section 9-301(1)(b), a security interest in intellectual property is subordinate to the interest of a person who becomes a lien creditor with respect to that intellectual property before the security interest is *perfected*.¹ Under this rule the creditor with a judicial lien on intellectual property should prevail over subsequent secured parties, as well as existing but unperfected secured parties.² The contest between a *prior* secured party

¹ U.C.C. § 9-301(1)(b)&(3). Compare U.C.C. [Revised] § 9-317(a)(2) ("a person who becomes a lien creditor before the security interest...is perfected *and before a financing statement covering the collateral is filed*"). The added italicized language extends a secured party's effective protection from the point of filing as it presently exists in section 9-301(1)(b). Even under the current language of 9-301(1)(b), a prior secured party with an *existing* and properly filed security interest covering after-acquired property is effectively protected against the lien creditor from the time of a proper filing. This result follows because a person cannot "become" a lien creditor until the debtor has rights in the collateral that enable the attachment of the judicial lien. U.C.C. § 9-301, cmt. 3. At the moment that the debtor acquires sufficient rights, however, the prior filed secured party with an effective after acquired property clause is immediately perfected in the acquired property. The best the "becoming" lien creditor can do is tie the filed secured party with an existing agreement covering after-acquired property. But, in order to subordinate the secured party under the present section 9-301(1)(b) language, the lien creditor must "become" a lien creditor *before* perfection. A tie goes to the existing secured party, so a lien creditor is effectively closed out of priority as soon as the secured party with an after-acquired property clause files a proper financing statement. See *Grain Merchants of Indiana, Inc. v. Union Bank and Savings Co.*, 408 F.2d 209, 212 (7th Cir. 1969) ("Thus we are presented with a situation where as soon as an account receivable comes into existence and is sought to be attached by a lien creditor, it has already become subject to a perfected security interest.") The language of the Revisions carries the protective effect of filing a financing statement vis-a-vis the lien creditor one step further, however. Under the language of Revised section 9-317(a)(2), a lien creditor loses to a secured party who did not even have an agreement covering the property at the time the competing judicial lien arose, as long as there was a filed financing statement "covering" the collateral. The new rule essentially gives the secured party a first-to-file priority over the lien creditor applicable even when the secured party has no existing security agreement covering the collateral at the time the competing third party "becomes" a lien creditor.

² Compare: T.Ward, *Ordering the Judicial Process Lien and the Security Interest Under Article Nine: Meshing Two Different Worlds*, 31 ME. L. REV. 223, 231 (1981) with D. Board, *The Scope of Article Nine Is Only One Quarter as Great as Is Commonly Supposed*, 47 U. MIAMI L. REV. 951, 981-87 (1993).

and a *subsequent* lien creditor is certainly the most important application of section 9-301(1)(b) because "perfection" in this scenario has major implications under the Bankruptcy Code.

The bankruptcy trustee who is charged with administering the estate and distributing available assets to creditors, has the status of a hypothetical creditor who acquired a judicial lien on the date of the bankruptcy petition.³ When Article Nine controls the question of "perfection," the rule in Section 9-301(1)(b) makes a security interest, which is unperfected as of the date of filing the bankruptcy petition, avoidable. The unperfected security interest, in this circumstance, is subordinate to the interest of the person who "becomes a lien creditor."⁴

Article Nine perfection is also important in bankruptcy because it marks the date on which many pre-bankruptcy transfers of security are "deemed" to occur. Under section 547 of the Bankruptcy Code, transfers of personal property (including intellectual property) to secure an antecedent debt that occur within a specified pre-petition period (90 days, or 1 year for "insiders") are generally "preferences" and subject to possible avoidance by the trustee.⁵ If the perfection of these transfers is delayed for more than ten days after the *actual* transfer of the collateral, the *transfer date* will be deemed to be the *date of "perfection."*⁶ Section 547(e) of the Bankruptcy

³ 11 U.S.C. § 544(a)(1) (1988). See also 11 U.S.C. § 550(a) (Supp. 1999)

⁴ Article Nine defines a "lien creditor" to include the "trustee in bankruptcy from the date of the filing of the petition..." U.C.C. § 9-301(3). Accord U.C.C. [Revised] § 9-102(a)(52)(C). Revised Article Nine gives priority to a secured party who does not even have a security agreement covering the collateral when the lien creditor "becomes" such, as long as the secured party has a proper filing "covering" the collateral. U.C.C. [Revised] § 9-317(a)(2). Although this first-to-file rule will help filed but "unattached" secured parties in competition with real judicial lien creditors when the security agreement arises after the lien creditor attaches, it will not help secured parties in bankruptcy. The date of the petition marks the trustee's lien creditor status under section 544(a)(1) of the Bankruptcy Code [11 U.S.C. § 544(a)(1) (1994)], and post-petition transfers of estate property are avoidable under section 549(a) of the Bankruptcy Code [11 U.S.C. § 549(a) (1994)].

⁵ 11 U.S.C. § 547(b) (1994).

⁶ 11 U.S.C. § 547(e)(2)(A)&(B) (1994). Note that under section 547(e)(3) of the Bankruptcy Code, no transfer occurs until the debtor has rights in the property transferred. 11 U.S.C. § 547(e)(3) (1994). See T. Ward & J. Shulman, *In Defense of the Bankruptcy Code's Radical Integration of the Preference Rules Affecting Commercial Financing*, 61 WASH. U.L.Q. 1, 28-36 (1983). Even if state law dates the secured party's priority over the lien creditor from the time a filing is made that covers the yet to be acquired property of the debtor, such early state law protection cannot be used to pre-date a transfer. The debtor must have rights in the collateral before a transfer can occur. Although Revised Article Nine gives the secured party priority over the lien creditor from the time of a filing "covering the collateral," [U.C.C. [Revised] § 9-317(a)(2)] that

Code references other law⁷ because it defines perfection as the point when the transfer of personal property collateral is protected against the ubiquitous "lien creditor."⁸ If, under this perfection-sensitive timing rule, the transfer of collateral under a security agreement is "deemed" to occur when the security interest in the transferred collateral is perfected, rather than when the agreement is executed and value is given, then in bankruptcy a new value exchange can become a debt followed by a *subsequent* securing transfer of collateral.⁹ These delayed transfers of collateral are preferential because they are deemed to have occurred after the creation of the debt.¹⁰ In the language of the Bankruptcy Code, they are transfers "for or on account of an antecedent debt."¹¹ If, in addition, a transfer so delayed occurs within the appropriate pre-petition preference period, and if allowing the transfer to stand would increase the secured party's take in bankruptcy, the transfer is generally a "preference."¹² Note that the same bankruptcy reference to "perfection" that is necessary to determine time for purposes of "antecedentness" can also mark the date of the transfer as either inside or

filing date cannot be used to date the debtor's transfer of collateral unless the debtor has actual rights in the collateral on that date.

⁷ For security transfers of intellectual property governed by state law, the "other law" is Article Nine. The perfection question should then center on whether or not the secured party has properly perfected an interest in *general intangibles* by filing in the correct office in the state where the *debtor is located*. See *Chesapeake Fiber Pkg. v. Sebro Packing Corp.*, 143 B.R. 360, 368-69 (D. Md. 1992)*aff'd*, 1993 U.S. App. LEXIS 28605 (4th Cir. 1993); *In re Transportation Design and Technology, Inc.*, 48 B.R. 635, 638-39 (Bankr. S.D. Cal. 1985). However, some forms of "embodied" or "installed" intellectual property (e.g. software) may be classified as *goods* under the current language of Article Nine and will need to be perfected by filing in the correct office in the state where the *goods are located*. See *In re C Tek Software, Inc.*, 117 B.R. 762, 768-69 (Bankr. D.N.H. 1990). But see U.C.C. [Revised] § 9-102(a)(42)&(75) ("software" classified as a "general intangible" under Revised Article Nine). When state law is preempted because a particular federal intellectual property statute governs the priority between the secured party and the lien creditor, the priority rules under that federal statute should be referenced in order to decide the issue of bankruptcy "perfection." *National Peregrine, Inc. v. Capital Federal Savings & Loan Ass'n*, 116 B.R. 194, 204-08 & n.17 (C.D. Cal. 1990).

⁸ 11 U.S.C. § 547(e)(1)(B) (1994).

⁹ U.S.C. § 547(e)(2)(A)&(B) (1994).

¹⁰ *Id.*; See also 11 U.S.C. § 547(b)(2) (1994).

¹¹ 11 U.S.C. § 547(b)(2) (1994). See also 1 D. Epstein, S. Nickles, J. White, *BANKRUPTCY* § 6-19 at 572-76 (1992).

¹² 11 U.S.C. § 547(b)(4)&(5) (1994). Section 547(b) also requires that the debtor be insolvent at the time of the transfer. However, the trustee has the benefit of a presumption that the debtor was insolvent for 90 days preceding the bankruptcy petition. See 11 U.S.C. § 547(f) (1994).

outside of the pre-petition preference period.¹³

2. Secured Party vs. Assignees and Licensees

a) The Transferee Rule

Under the current section 9-301(1)(d), "a person who is a transferee" of a general intangible has priority over a security interest "to the extent that he gives value without knowledge of the security interest and before it is perfected."¹⁴ An assignee of intellectual property qualifies as both a "purchaser" under the presumption language in section 9-201 and a "transferee" under the priority rule in section 9-301(1)(d).¹⁵ Subsection (d), therefore, provides the person *who is such a transferee* a kind of priority exception from the section 9-201 presumption in favor of the security interest as long as that person *gives value* without knowledge of the security interest and *before it is perfected*.¹⁶

The priority rule in section 9-301(1)(d) does not play out as neatly, however, when a *prior perfected* secured party comes up against a later licensee who takes no interest in the intellectual property. Such a licensee seems to be less than a section 9-201 "purchaser"¹⁷ and therefore is outside the reach of the predicate presumption in favor of the secured party.¹⁸ However, such a licensee is still a transferee and finds no comfort as against

¹³ 11 U.S.C. § 547(b)(4) (1994). "For purposes of this section...a transfer is made ...(B) at the time such transfer is perfected, if such transfer is perfected after such 10 days..." 11 U.S.C. § 547(e)(2)(B) (1994). See 1 D. Epstein, S. Nickles, J. White, *Bankruptcy* § 6-12 (1992).

¹⁴ U.C.C. § 9-301(1)(d). See also U.C.C. [Revised] § 9-317(d).

¹⁵ "Transfer" is not defined in Article Nine. However, the definition of "purchase" in section 1-201(32) is broad enough to include "any...voluntary transaction creating an interest in property." U.C.C. § 1-201(32). Any transfer of an interest in intellectual property appears to make the receiving party both a "transferee" and a "purchaser." The presumption of priority provided by section 9-201 is effective against "purchasers of the collateral and creditors." U.C.C. § 9-201. Transferees are not mentioned in section 9-201. However, some transferees (those that take an interest in property) are included under the definition of a "purchaser." U.C.C. § 1-201(32).

¹⁶ U.C.C. § 9-301(1)(d).

¹⁷ U.C.C. § 1-201(32)&(33). Revised Article Nine includes an amended definition of "purchase" in Article 1 that expressly includes a "security interest." U.C.C. [Revised] § 1-201(32).

¹⁸ U.C.C. § 9-201.

a perfected secured party under the language in section 9-301(1)(d).¹⁹ The law outside of Article Nine does not help the nonpurchaser/licensee. A first-in-time secured party will argue that common law gives the licensee only what the debtor had to license—rights subject to a perfected security interest.²⁰ If the perfected secured party takes ahead of a subsequent purchaser/licensee with ownership rights, it should have no less right against a subsequent nonexclusive licensee who takes no proprietary right in the intellectual property. The Preliminary Report of the ABA Task Force on Security Interests in Intellectual Property concludes that a *prior perfected* secured party would prevail against a subsequent licensee.²¹ This position applies the section 9-201 presumption and the section 9-301(1)(d) exception when the licensee is a purchaser with "an interest in property"²² under the license. The ABA position logically extends these provisions when the licensee takes only a "personal" right.²³

The counterparts in Revised Article Nine to the current rules in sections 9-201 and 9-301(1)(d) are found in Revised sections 9-201 and 9-317(d).²⁴ Unfortunately, section 9-201 of the Revisions retains the current language that brings only "purchasers" within the general presumption in favor of the effectiveness of the security interest.²⁵ Section 9-317(d) of the Revisions, on the other hand, creates an exception from the 9-201 presumption that protects both innocent "licensees" and innocent "buyers" of

¹⁹ U.C.C. § 9-301(1)(d).

²⁰ *Bank of the West v. Commercial Credit Financial Services, Inc.*, 852 F.2d 1162, 1174 (9th Cir. 1988)(Because the Article Nine priority rules fail to address the issue of secured parties with the same collateral but different debtors, the Court falls back on the derivative title principal that a transferee's creditor can have no greater rights in the collateral than does its transferee.)

²¹ Task Force On Security Interests in Intellectual Property, Business Law Section, American Bar Assoc. (June 1, 1992). Note, however, that nonexclusive licensees in the ordinary course are separately protected in Revised Article Nine under the language in Revised section 9-321(b). See U.C.C. [Revised] § 9-321(b).

²² U.C.C. § 1-201(32)&(33).

²³ See generally, Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priority Among Creditors*, 88 YALE L.J. 1143, 1161-64 & 1178-82 (discussing the relationship of the first-in-time principle and the notice filing premise of Article Nine). If the first-in-time principle controls in the case of a subsequent licensee, the prior secured party should prevail even if the security interest is unperfected. This specific priority rule is taken up in the context of other provisions that might give more express protection to subsequent licensees.

²⁴ See U.C.C. [Revised] § 9-201(a) & § 9-317(d).

²⁵ U.C.C. [Revised] § 9-201 & [Revised] § 1-201(32)(definition of "purchase" amended to expressly include "security interest").

general intangibles against unperfected security interests.²⁶ Although the word "licensee" in section 9-317(d) is not defined, the rule seems designed to protect all licensees, including nonexclusive licensees who would never get title. The Revisions retain the same BFP-type qualifying conditions as the current rule.²⁷

Both the current rule in section 9-301(1)(d) and the new rule in section 9-317(d) of the Revisions should allow a *prior perfected* secured party to prevail against a subsequent assignee and a subsequent "nonpurchaser"/licensee of the debtor's intellectual property. Both versions of the statute would be improved, however, if the definition of "purchaser," as that term is used in section 9-201 presumption, would include a common licensee.

b) Ordinary Course Licensees Rule

Revised Article Nine goes further than section 9-317(d), by protecting nonexclusive *ordinary course* licensees against prior perfected secured parties. Section 9-321(b) of Revised Article Nine gives priority to the subsequent nonexclusive licensee of a debtor's general intangible who takes from its licensor in the ordinary course against a prior perfected security interest created by the licensor. This priority holds even when the license is not authorized by the secured party and the licensee is aware of the security interest.²⁸ Note, however, that Revised section 9-321(b) retains the

²⁶ U.C.C. [Revised] § 9-317(d). Although the Revisions do not define either "licensee" or "buyer," the most recent draft of Revised Article 2 defines "buyer" as "a person that buys or contracts to buy." "Sale" is defined in the Article Nine Revisions by reference to Article 2, which requires a "passing of title." U.C.C. § 2-106(1). See also Draft U.C.C. § 2-102(3)("buyer") & § 2-102(27)("sale") (Discussion Draft, May 1, 1998). Revised Article Nine also adopts the Article 2 definition of "sale" by reference. U.C.C. [Revised] § 9-102(b).

²⁷ U.C.C. [Revised] § 9-317(d).

²⁸ U.C.C. [Revised] § 9-321(b) Revised section 9-321(a) defines a "licensee in the ordinary course of business." Revised section 9-321(b), as it was approved by the American Law Institute in May 1998 and the National Conference of Commissioners on Uniform State Laws in July of 1998, protected all licensees in the ordinary course, not just "nonexclusive" licensees. Apparently, the last minute change was prompted by pressure from segments of the Copyright Bar that did not want the protection of section 9-321(b) extended to exclusive copyright licensees. Recall that all exclusive licensees of a copyright take a "transfer of copyright ownership." The logic behind the change is not entirely clear. The broader protection of the prior language covered exclusive patent and trademark license who do not necessarily take an ownership interest with such a license. Furthermore, the prior language would not have protected an exclusive copyright licensees who took an "ownership" interest under what was essentially a horizontal transfer of a capital asset because such a license would not be "in the ordinary course."

restriction, borrowed from the analogous “goods” rule in Revised section 9-320(a),²⁹ that an ordinary course licensee only takes free of a security interest created by its immediate licensor. If for example, the licensor grants an unauthorized exclusive license to use the intellectual property while such property is already subject to a perfected security interest created by the licensor, the exclusive licensee takes subject to the perfected security interest. If thereafter, the exclusive licensee grants a nonexclusive sublicense, the nonexclusive licensee could not rely on section 9-321(b) for protection against the secured party, even if the sublicense was taken in the ordinary course. The nonexclusive sublicensee would not hold the sublicense free of the original perfected security interest because that interest was not created by its immediate ordinary course licensor.

c) Authorized Transfers

The protection for transferees provided by the priority rules in current section 9-301(1)(d) and Revised section 9-317(d) is augmented by the Article Nine rule on authorized transfers of collateral. Assignees and licensees of the debtor/licensor’s intellectual property are protected against a *prior perfected* security interest whenever the assignment or license is a “disposition” that is “authorized” by the secured party.³⁰ Most assignees and some licensees in the ordinary course will find protection under this rule because these kinds of transfers are nearly always expressly or impliedly authorized “free and clear of the security interest.”³¹

Current Article Nine section 9-306(2), protects subsequent assignees more clearly than subsequent licensees because section 9-306(2) refers to an authorized *disposition*. Recall from prior discussion that a section 9-306(2) “disposition” has been interpreted to mean a transfer or exchange of some underlying intellectual property. If an authorized licensee—even an exclusive licensee—is merely buying a nontransferable personal right, rather than making a disposition of property, the licensee would still seem to be subject to the prior perfected security interest, even though the transfer was authorized. This seems particularly unfair to these subsequent licensees. An authorized license represents the licensor’s effort to exhaust the value of

²⁹ U.C.C. [Revised] § 9-320(a).

³⁰ U.C.C. § 9-306(2). It must be an express or implied authority to license “free and clear of the secured parties security interest.” U.C.C. § 9-306, Comment 3. *See also*, U.C.C. [Revised] § 9-315(a)(1)(the revised language expressly requires that the secured party authorize disposal “free of the security interest.”)

³¹ *Tanbro Fabrics Corp. v. Deering Milliken, Inc.*, 39 N.Y.2d 632, 385 N.Y.S.2d 260, 350 N.E.2d 590, 19 UCC 385 (1976); *In re Tacoma Boatbuilding Co.*, 158 B.R. 19, 22 (S.D.N.Y. 1993).

some particular aspect of the exclusive right that is the intellectual property. If the prior secured party authorizes that attempted exploitation (expressly or impliedly), it should have a right in the resulting income stream (proceeds), but it should not have a right to upset the license if the licensor defaults. Courts should opt for the broader notion of substitute value when defining a "disposition" under current section 9-306 in order to protect these authorized, but non-proprietary, licenses.³²

Revised Article Nine rejects the overly narrow definition of "disposition" that has marked section 9-306 case law.³³ The broader "substitute value" notion of disposition in the Revisions will protect many ordinary course licensees against even perfected secured parties because many licenses will now be covered transfers expressly or impliedly authorized "free of the security interest."³⁴

³² Revised Article Nine contains a broader definition of "proceeds" that embraces the concept of substitute value. U.C.C. [Revised] § 9-102(a)(64). The new definition not only makes the proceeds rule more accommodating to intellectual property, but it also protects the limited rights of subsequent nonexclusive licensees against secured parties who expressly or impliedly gave authority to license to the debtor. U.C.C. [Revised] § 9-315(a). Section 9-315(a) adds the word "license" to the set of events that do not destroy the security interest *unless authorized*. Under the Revisions, even when authorized licensees take a mere personal right in the underlying intellectual property, they will take free of any claim by the prior authorizing secured party. *See also* Superseded Draft U.C.C. Revised Article Nine, Reporters' Prefatory Comments No.5(f) (Proposed Final Draft, April 15, 1998).

³³ *See* U.C.C. [Revised] §9-102(a)(69). *See* U.C.C. [Revised] §9-315(a); Superseded Draft U.C.C. Revised Article Nine, Reporters' Prefatory Comments No. 5(f) (Proposed Final Draft, April 15, 1998).

³⁴ U.C.C. [Revised] § 9-315(a). Many prior secured parties expect that their debtor will license technology covered under the security interest, and look to the debtor's licensing income as the source of repayment. These prior perfected secured parties should lose to subsequent licensees with respect to the licensed right because they have authorized the exploitation of the collateral. However, if the debtor's intellectual property is used in conjunction with its own in-house manufacturing or production activity, the secured party should not be deemed to have authorized subsequent licensing activity. If the debtor begins to farm out its intellectual property without seeking the secured party's consent, authorization should not be presumed and the license should not be treated as one in the "ordinary course."

3. Secured Party vs. Secured Party

a) The First to File Rule

Priority conflicts between two non-purchase-money security interests in the same collateral are *not* resolved by the order of perfection. These common conflicts between secured parties are resolved by giving priority to the first party to *file* a proper financing statement covering the collateral.³⁵ The *order of filing* is different from the *order of perfection* because under Article Nine filing can occur before attachment and before *any* of the elements necessary for attachment.³⁶

The recording and BFP rules in the federal intellectual property statutes add another interesting and limiting dimension to the operation of the Article Nine race priority rule. A debtor/owner of this property must also record or run the risk that its underlying rights in the collateral will be displaced in favor of a subsequent bona fide purchaser.³⁷ The first-to-file rule is premised on the assumption that both competing secured parties take their security interest from the same debtor who has good title.³⁸ When the collateral rights of different debtors underlie the two competing security interests, secured party priority will turn on the resolution of priority between the underlying debtor/owners, not the order of filing between the secured parties.³⁹

³⁵ U.C.C. § 9-312(5)(a). The first-to-file rule is a residual rule that does not protect a party who has *filed* yet remains unperfected when priority must be determined, because the security interest has never *attached*. "So long as conflicting security interests are unperfected, the first to attach has priority." U.C.C. § 9-312(5)(b). *See also* U.C.C. [Revised] § 9-322(a)(1),(2)&(3).

³⁶ U.C.C. § 9-402(1).

³⁷ 35 U.S.C. § 261 (1994); 17 U.S.C. § 205 (1994); 15 U.S.C. § 1060 (1994).

³⁸ *Bank of the West v. Commercial Credit Financial Services, Inc.*, 852 F.2d 1162, 6 UCC2d 602 (9th Cir. 1988) ("We think the correct result is reached in this case by applying the common sense notion that a creditor cannot convey to another more than it owns. Put another way, the transferee, Allied, cannot acquire any greater rights in the beverage business's assets than its transferor, BCI, had in them.") *Id.* at 1174, *citing*, U.C.C. § 2-403(1). *See* J. White & R. Summers, *UNIFORM COMMERCIAL CODE* § 24-19(d) at 897-98 (4th ed. 1995). *See also* U.C.C. [Revised] § 9-325, cmt. 6. These derivative title questions are examined in THOMAS M. WARD, *INTELLECTUAL PROPERTY IN COMMERCE* §§ 2:20 and 2:46 (2000).

³⁹ *Id.*

b) The Purchase Money Priority Rule

As the prior section illustrates, the secured creditor who wins the race to the file holds an unusually strong position vis-a-vis other parties interested in extending credit to the debtor. Article Nine qualifies the strength of this first-to-file position by providing a kind of super-priority for "purchase-money" security interests. These purchase-money secured parties must provide the debtor with new value. Two kinds of credit extenders can have purchase-money status. First, the status is afforded to the secured credit seller on the property *sold* and retained as security. Second, any secured party whose credit *directly enabled* the debtor to purchase the collateral has "purchase-money" status to that extent.⁴⁰ Once a secured party satisfies the threshold test for purchase-money treatment, sections 9-312(3) and (4) provide separate scenarios under which the purchase-money interest qualifies for super-priority in the purchased property. This priority runs against both prior and subsequent secured parties.⁴¹

Current Article Nine permits the creation of a purchase-money security interest in any "collateral."⁴² Following up on this general reference to "collateral," the priority rule in current section 9-312(4) creates an exception from the first-to-file priority rule for the purchase-money secured party with an "interest in *collateral* other than inventory."⁴³ Subsection (4) provides:

A purchase-money security interest in collateral other than inventory has priority over a conflicting security interest in the same collateral or its proceeds if the purchase-money security interest is perfected at the time the debtor *receives possession* of the collateral or within ten days thereafter.⁴⁴

⁴⁰ An interest in "collateral" sold is purchase-money if it is "taken or retained by the seller." U.C.C. § 9-107(a). The enabling credit given by a nonseller also creates purchase-money status in the collateral, but only if the value given "is in fact so used" to purchase the collateral. U.C.C. § 9-107(b). See 2 G. Gilmore, §9.2 @ 781-782 (1965); J. White & R. Summers, UNIFORM COMMERCIAL CODE § 24-5 at 859-60 (4th ed. 1995). See also U.C.C. [Revised] § 9-103(a)(2).

⁴¹ U.C.C. § 9-312(3)&(4).

⁴² U.C.C. § 9-107(a)&(b).

⁴³ U.C.C. § 9-312(4) (Emphasis added.) Compare U.C.C. [Revised] § 9-324(e).

⁴⁴ U.C.C. § 9-312(4) (Emphasis added.) The counterpart rule in Revised Article Nine, section 9-324(e), applies to "goods other than inventory" rather than "collateral other than inventory." The proposed rule limits subsection (e) purchase-money priority in proceeds whenever these proceeds find their way into a deposit account controlled by another secured party. See U.C.C. [Revised] § 9-324(e) & § 9-327. Finally, the ten (10) day grace period under current law is extended to twenty (20) days under Revised Article Nine. *Id.*

Herein lies the problem with applying purchase-money priority to intellectual property collateral. Subsection (4) makes "the time the *debtor receives possession of the collateral*" the point from which the mandatory purchase-money filing must be made in order to obtain priority over other security interests. Most commentators interpret this reference to possession in the section 9-312(4) priority rule to mean that those financing an acquisition of intellectual property will not have purchase-money priority, because they cannot "possess" the property.⁴⁵ Unfortunately, the language of Revised Article Nine incorporates an even narrower notion of purchase-money collateral. The definition of "purchase money collateral" in Revised section 9-103(c) is limited to "goods" and supporting "software."⁴⁶ To qualify for a purchase-money supporting role, "software" must be part of an integrated transaction and it must be incidental to the purchase-money interest in the goods in which it is embedded.⁴⁷

In a commercial environment, where more of the debtor's new value opportunities will appear in the form of intellectual property, Revised Article Nine should be revised to broaden the reach of purchase-money priority. Instead of limiting the range of purchase-money status, the Permanent Editorial Board should define "purchase money collateral" in section 9-103(a) to include goods and general intangibles that are not "payment intangibles."⁴⁸ Furthermore, the purchase-money priority rule in Revised

⁴⁵ J. Honold, S. Harris & C. Mooney, *CASES, PROBLEMS AND MATERIALS ON SECURITY INTERESTS IN PERSONAL PROPERTY* 323 (1992); Grant Gilmore concluded that:

"Collateral other than inventory thus comes down to equipment...consumer goods...farm products which are purchased by a farmer..., and (but this is almost on a hypothetical level) *general intangibles*." (Emphasis added.) 2 G. Gilmore, *supra* note 40 at § 29.5 at 798 (1965).

See also *James Talcott, Inc. v. Associates Capital Co.*, 491 F.2d 879 (6th Cir. 1974); *In re Automated Bookbinding Servs. Inc.*, 471 F.2d 546 (4th Cir. 1972); *North Platte State Bank v. Production Credit Ass'n*, 189 Neb. 44, 200 N.W.2d 1 (1972); *In re Michaels*, 156 B.R. 584 (Bankr. E.D. Wis. 1993); *In re Ivie & Associates, Inc.*, 84 B.R. 882 (N.D. Ga. 1988). These courts interpret, the phrase "receives possession" in 9-312 (4) separately from possession as a mode of perfection as interpreted in 9-305.

⁴⁶ U.C.C. [Revised] § 9-103(a)(1).

⁴⁷ U.C.C. [Revised] § 9-103(c) & § 9-324(f).

⁴⁸ "Payment intangibles" are general intangibles "under which the account debtor's principal obligation is a monetary obligation." U.C.C. [Revised] § 9-102(a)(61). If "payment intangibles" are excluded, then bringing general intangibles under the definition of purchase money collateral in Revised section 9-103(a) will not bring receivables along as well, because the definition of "accounts" has been expanded to include all other commercially significant receivables [U.C.C. [Revised] § 9-102(a)(2)], and the definition of a "general intangible" does not include an "account." U.C.C. [Revised] § 9-102(a)(42).

section 9-324(e) should be amended to embrace "purchase-money collateral other than inventory or livestock," and the grace period language in Revised section 9-324(e) should be amended to read: ". . . *if the purchase-money security interest in goods is perfected at or within ten days from the time the debtor receives possession of the collateral, or, in the case of general intangibles other than payment intangibles, at or within ten days from the time the debtor acquires rights in the collateral.*"

APPENDIX 15 - PEREGRINE: THE COMPLETE PREEMPTION CASE

A. The Peregrine Holding

The narrow issue in *Peregrine* involved "perfection" of copyright collateral and related receivables. In an earlier Bankruptcy Court decision, the secured party, Capital Federal, sought to enforce a security agreement covering film copyrights.¹ Capital had filed U.C.C. Article Nine financing statements covering the collateral described in its security agreement in several states. However, Capital did not record the security agreement or a memorandum thereof as a "transfer of copyright ownership" in the Federal Copyright Office. The debtor-in-possession (armed with the rights of a bankruptcy trustee) moved the Bankruptcy Court to treat Capital's security interest as "unperfected" in the absence of a Copyright Office recording. If Capital's interest was not perfected under Article Nine, it would be vulnerable to a lien creditor under section 9-301(1)(b).² Because the debtor-in-possession had the rights of a hypothetical lien creditor under section 544(a)(1) of the Bankruptcy Code, Capital's security interest could be avoided.³ The controversy was framed in the Bankruptcy Court, as a filing issue under the partial step-back rule in section 9-302(3).⁴ The issue turned on whether the state filings perfected the security interest for purposes of the state law priority rule in Article Nine section 9-301(1)(b) or whether the Copyright Act recording requirements displaced the otherwise appropriate state filing under U.C.C. section 9-302(3)&(4).

In light of the partial step-back language in Article Nine section 9-302(3)(a) and (4), the Bank's security interest seems to have been unperfected as a matter of state law. As explained in Section II(f)(3), Official Comment 8 to section 9-302 clearly identifies the recording provisions of the Copyright Act as "a statute . . . of the United States which provides for a national . . . registration" within the meaning of the deferral rule in section 9-302(3)(a). Subsection (4) of section 9-302 further provides that compliance with such a displacing "statute of the United States"

¹ 116 B.R. at 198.

² Under section 9-301(1)(b), an unperfected security interest "is subordinate to the rights of . . . a person who becomes a lien creditor before the security interest is perfected." U.C.C. § 9-301(1)(b).

³ 11 U.S.C. § 544(a)(1) (1988).

⁴ *In re National Peregrine, Inc.*, No. 89-01991-LF, 1989 Bankr. LEXIS 2469 at *9 (Bankr. C.D. Calif. 1989).

becomes the exclusive method of perfection. Nevertheless, the Bankruptcy Court ignored section 9-302(4) and concluded that, while Capital could have "perfected" by recording in the Copyright Office, its U.C.C. filing was sufficient to give it priority against the hypothetical lien creditor.⁵ The Bankruptcy Court decision seemed clearly mistaken regarding the effect of a displacing national registry under the partial step-back in section 9-302(3)(a) and (4), and the debtor in possession took an appeal to the District Court. Recognition of a "partial step-back" of Article Nine *filing* rules in favor of the Copyright Act's national registration would have provided a sufficient basis on which to overturn the Bankruptcy Court and give the debtor-in-possession the right to avoid the Bank's security interest in debtor's copyrights, because Capital's state filing was not effective *under Article Nine* to perfect its security interest in the copyright.

Indeed, in reversing the Bankruptcy Court, the District Court that a security interest in a copyright could *only* be perfected by filing in the Copyright Office.⁶ However, that point is clearly set out in the applicable state law. Instead of recognizing the propriety of Copyright Act recording under state law, the District Court made a federal case out of the proper perfection of a security interest in a copyright. The court passed on the chance to pair the Copyright Office filing mandated by the partial step-back in U.C.C. section 9-302(3)&(4) with the Article Nine priority scheme.⁷ According to the District Court, the partial step-back for filing was not enough preemption. Relying on the complete step-back language in section 9-104(a) and the federal preemption doctrine,⁸ the Court concluded that all of Article Nine was displaced by the Copyright Act, including its priority rules. According to *Peregrine*, Article Nine did not control perfection or the rights of *any* of the parties, *including the bankruptcy trustee who stands in the shoes of a lien creditor*.⁹

⁵ Bankr. LEXIS 2469 at *14 ("Therefore, filing in the Copyright Office is not necessary or effective to perfect a security interest in copyrights, licenses, or the proceeds thereof, against a lien creditor."). See also 116 B.R. at 201.

⁶ 116 B.R. at 203.

⁷ The Bankruptcy Court for the District of Arizona did not pass up the chance in 1997, however. See *In re Avalon Software, Inc.*, 209 B.R. 517, 522-23 (Bankr. D. Ariz. 1997).

⁸ 116 B.R. at 202-03 & 199-201. The *Peregrine* Court noted that the 1976 Copyright Act created a federal recording system for copyrights and that the purpose of the system was to "promote national uniformity." 116 B.R. at 199, *quoting*, Community for Creative Non-Violence v. Reid, 490 U.S. 730, 740 (1989). In cases involving copyrights and the *proceeds* of copyrights (copyright-based receivables), the federal system is equipped to handle both the consensual security interest and the nonconsensual levy. According to the Court any competing recording system would hamper the nationwide effectiveness of the federal scheme, . 116 B.R. at 204-08 & n.17.

⁹ 116 B.R. at 205-07.

B. *Peregrine and Later Transfer*

In order to displace the comprehensive Article Nine priority rules, the Court applied a federal law, which covers the same interests otherwise protected by section 9-301(1)(b) of Article Nine. Within the sparse language of 205(d) of the Copyright Act, the Court found language, which handled the conflict between the secured creditor and the "lien creditor" who was given hypothetical life under section 544(a) of the Bankruptcy Code.¹⁰ The court's construction of section 205(d) of the Copyright Act and resulting analysis of the *Peregrine* opinion is not solid.¹¹

Ironically, the *Peregrine* holding that a complete step-back from Article Nine was mandated provided Capital with an argument that would have been unavailable under the Article Nine partial step-back priority scheme. Capital argued that if the Copyright Act completely occupied the priority field, it must have a rule protecting the lien creditor from prior unrecorded transfers, or the unrecorded security interest would prevail in bankruptcy.¹² In order to find that Capital's security interest could be set aside because it was unrecorded under the Copyright Act, the *Peregrine* Court had to identify a priority rule in section 205(d) of the Act that protected a later lien creditor against a prior unrecorded transfer of copyright ownership. Such a rule is clearly set out in Article Nine section 9-301(1)(b).¹³ But, given the sparse priority rule language contained in section 205(d) of the Copyright Act, finding the functional equivalent of section 9-301(1)(b) seemed like a tall order.

While the involuntary lien might very well be considered a "transfer of copyright ownership" as broadly defined by section 101 and section 201(d)(1) of the Copyright Act, the priority rule for "conflicting transfers" in section 205(d) does not seem to provide for involuntary transfers. Later transfers which escape the grace period and are first recorded prevail against prior unrecorded transfers only if "taken in good faith for valuable consideration."¹⁴ This language seemingly excludes an ordinary judgment creditor whose involuntary lien is never taken in exchange for consideration provided to the debtor and thus is never "for valuable consideration."¹⁵ The

¹⁰ 116 B.R. at 205-06.

¹¹ The lien creditor priority rule under Revised Article Nine is found in Revised section 9-317(a)(2). U.C.C. [Revised] § 9-317(a)(2).

¹² 116 B.R. at 206.

¹³ U.C.C. § 9-301(1)(b).

¹⁴ 17 U.S.C. § 205(d) (1994).

¹⁵ It can be argued that a judgment creditor acquires no rights in a federal copyright still owned by the author. Section 201(e) provides that:

Peregrine Court avoided this gap in section 205(d) priority by relying on the *hypothetical*, and, in this case, *artificial* nature of the lien creditor's special bankruptcy *persona*. Under section 544(a)(1) of the Bankruptcy Code, the trustee has the rights of a judicial lien creditor who also "extends credit to the debtor" on the date of the petition. Based on this artificial, but unavoidable, timing restriction, the Court concluded that the section 544(a)(1) lien creditor did, in fact, "take" for "a valuable consideration" within the meaning of section 205(d) of the Copyright Act.

This is nothing more than questionable finesse around the obvious voluntary transferee-for-value language of section 205 of the Copyright Act. Such logic also runs counter to the policy underlying the hypothetical simultaneous credit extension used to limit the right described in section 544(a)(1) of the Bankruptcy Code.¹⁶ The date of the credit extension in 544(a)(1) coincides with the birth of the lien so that the trustee cannot *advance* the date on which the hypothetical lien creditor extended credit. Without this restriction, the trustee might invent the date of a credit extension to take advantage of the occasional state law giving rights to a creditor who *extends* unsecured credit in the gap between the execution of another creditor's security agreement and the recording or perfection of that interest.¹⁷ This timing language was never intended to permit the trustee to promote the simple lien creditor to the status of a voluntary for-value transferee.¹⁸ Even if

When an individual author's ownership of a copyright, or of any of the exclusive rights under a copyright, has not previously been transferred voluntarily by that individual author, no action by any governmental body or other official or organization purporting to seize, expropriate, transfer, or exercise rights of ownership with respect to the copyright, or any exclusive rights under a copyright, shall be given effect under this title, except as provided under title 11. 17 U.S.C. § 201(c) (1994). The purpose of this section was to limit the extent of copyright control that the government of the former Soviet Union could exercise over the dissemination of works by Soviet authors of which the government did not approve. The language is much broader than the purpose behind it, however. The language of this section can be read to prohibit any involuntary transfer of an author-owned copyright outside of bankruptcy that relies on governmental action. This reading of section 201(e) should be rejected. Although the parties failed to raise the issue in *Peregrine*, the Court correctly limited section 201(c) to actions *initiated by and for* governmental bodies. 116 B.R. at 205-206, n.16.

¹⁶ Capital argued that the trustee needed the status of a subsequent purchaser to find protection under the priority rule in section 205(d). 116 B.R. at 206.

¹⁷ In *Constance v. Harvey*, 215 F.2d 571 (2d Cir. 1954), *cert. denied*, 348 U.S. 913 (1955), the Second Circuit held that the trustee, as hypothetical lien creditor under section 70(c), could hypothecate a credit extension in the gap between the creation and perfection of a chattel mortgage, even though the mortgage had been filed and perfected before the petition date. The Supreme Court overruled *Constance v. Harvey* in *Lewis v. Manufacturers National Bank*, 364 U.S. 603 (1961).

¹⁸ 4 Collier on Bankruptcy ¶ 544.02 at 544-11 to 544-13 (1986). See Paul Heald, *Resolving*

the language of 544(a)(1) can be stretched as *Peregrine* suggests, the trick works only when the *hypothetically created* lien creditor competes with the secured party in bankruptcy; it does not make 205(d) applicable to real involuntary liens that arise well after the debt is incurred under state judicial lien law. In that very important sense, the priority scheme of section 205(d) is incomplete. Despite the gap, however, *Peregrine* finds the priority scheme of section 205(d) sufficient to displace the priority rules in Article Nine.

The mischief that results from finding a lien creditor lurking in the later transfer language of section 205(d) extends far beyond security interests in copyright collateral. If federal law does indeed protect the lien creditor as a "later for-value transferee," then all unrecorded transfers of copyright ownership are vulnerable to the bankruptcy trustee after the grace period has expired.¹⁹ In some cases, these unrecorded or late-recorded transfers may also be vulnerable as preferences under section 547 of the Bankruptcy Code.²⁰

C. *Peregrine and Security Interests in Receivables*

Peregrine mandates that a security interest in copyright royalties, or other receivables generated by a copyright, must be recorded under section 205 of the Copyright Act in order to be "perfected."²¹ *Peregrine* assumes receivables generated by copyright collateral are so integral to the copyright ownership rights transferred for security that they must also fall within the preemptive shadow of the Copyright Act. While royalties are clearly important to copyright owners, they do not arise naturally from the federal statutory basis for copyright ownership. Instead they are the direct by-

Priority Disputes in Intellectual Property Collateral, 1 J. INTELL. PROP. L. 135, 144 (1993)(Copyright Act section 205(d) does not allow the debtor-in-possession to prevail against an unperfected security interest.).

¹⁹ 11 U.S.C. § 544(a)(1) and § 546(b) (1994).

²⁰ 11 U.S.C. § 547(b)&(e) (1994).

²¹ *National Peregrine, Inc. v. Capital Federal Savings & Loan Ass'n.*, 116 B.R. 194, 199 (C.D. Cal. 1990). Applying only a partial step-back to Article Nine filing, the decision in *Avalon Software* also mandates Copyright Office recording for copyright based receivables. See *In re Avalon Software, Inc.*, 209 B.R. 517, 523 (Bankr. D. Ariz. 1997). The underlying rationales in the two cases are not the same, however. *Peregrine* seems to treat receivables as a necessary incident to copyright ownership *under federal law*. *Avalon Software* seems to treat royalties as "proceeds" *under state law* that are unperfected if the copyright collateral is unperfected. With respect to the holding in *Avalon Software*, it should be remembered that section 9-306(1), in its present form, requires that a license result in a "disposition" of copyright property before proceeds are generated.

product of private contractual agreements that have traditionally been the domain of state law.²² Extending the reach of the preemption doctrine to cover generated receivables in *Peregrine* may be more questionable than the use of preemption to displace Article Nine priority rules.²³

The underlying rationale for the *Peregrine* position on receivables seems to have been trumped by the Ninth Circuit in *Broadcast Music, Inc. v. Hirsch*.²⁴ In *Broadcast Music* the Court held that an assignment of the right to receive copyright royalties was not a transfer of copyright ownership under section 205(a) of the Copyright Act, and that such assignment did not need to be recorded to defeat a subsequent tax lien.²⁵ The Ninth Circuit refused to extend its holding expressly to transfers for security, and therefore to *Peregrine*.²⁶ However, the Ninth Circuit's statement that "[a]ssignments of interests in royalties have no relationship to the existence, scope, duration or identification of a copyright, nor to 'rights under a copyright'" seems to undercut the premise behind *Peregrine's* extension of section 205 preemption to copyright-based receivables.²⁷ The *Peregrine* Court viewed/characterized the security interest in copyright-based receivables not only as a recordable transfer under the Act, but as a vulnerable recordable transfer absent a recording under section 205(d) [remember *Peregrine* saw a complete preemption].²⁸ *Peregrine's* conclusion that receivables not recorded under section 205(a) and (c) lose to the lien creditor under section 205(d), depends on the premise that such receivables fall within the broad definition of a "transfer of copyright ownership." In *Broadcast Music*, the Ninth Circuit found an ordinary assignment of such receivables did not fit within

²² Aronson v. Quick Point Pencil Co., 440 U.S. 257, 266 (1979); McCoy v. Mitsubishi Cutlery, 67 F.3d 917, 922 (Fed. Cir. 1995), *cert. denied*, 116 S. Ct. 1268 (1996)(licenses conform to state law); Power Lift, Inc. v. Weatherford Nipple-Up System, 871 F.2d 1082, 1085 (Fed. Cir. 1989)(patent license is a contract to be construed under state law). See Robert Rotstein, Paul Heald's "Resolving Priority Disputes in Intellectual Property Collateral": A Comment, 1 J. INTELL. PROP. L. 167, 182-83 (1993)(Proceeds derived from copyright are not within the scope of section 106 of the Act and are not "work-based" assets for recordation purposes.).

²³ "[Federal law] may not be invoked...merely because...the property involved was obtained under federal statute." Puerto Rico v. Russell & Co., 288 U.S. 476, 483 (1933)(Brackets added). See A. Haemmerli, *supra* note 668 at 1680-94. The article soundly refutes the *Peregrine* assumption that federal preemption doctrine mandates section 205 recording and priority apply to security interests in copyright receivables.

²⁴ 104 F.3d 1163 (9th Cir. 1997).

²⁵ 104 F.3d at 1166 & 1168.

²⁶ 104 F.3d at 1166-67.

²⁷ 116 B.R. at 199.

²⁸ 116 B.R. at 205-07.

that definition. Assignments for security would seem to follow the same logic.

D. Peregrine and Perfection

In a classic example of understatement, Judge Koziniski noted that “filing with the Copyright Office can be much less convenient than filing under the U.C.C.” Since a Copyright Office filing is accomplished by reference to the registration number of an existing work. Recording a security interest in the specific copyright assets of a debtor with a fluid inventory of these assets (e.g., a film library) will involve “dozens, sometimes hundreds, of individual filings.”²⁹ As the actual inventory changes, either because different works are bought and sold or because the production of a final work must go through many stages with each stage being a distinct work in its own right, the secured party will be required to make a separate Copyright Office filing for each work added to or deleted from the library. Article Nine, by contrast, provides a blanket notice filing on all after-acquired property, thus giving the creditor a continuing, floating lien on the debtor’s copyright without the need for periodic updates.³⁰

The link between recording and registration of an “existing work” is not, however, a “Condition of Recordation” under section 205(a) of the Copyright Act. Subsection 205(a) provides that “[a]ny transfer of copyright ownership or other document pertaining to a copyright may be recorded”³¹ The only condition imposed on recording under subsection (a) is that the document “bears the actual signature of the person who executed it, or ... is accompanied by a sworn or official certification that it is a true copy of the original, signed document.”³² The link arises out of the language in section 205(c) and (d) governing effectiveness of a recording for purposes of priority against subsequent transferees. Under subsection (d) only a recording “in the manner required to give constructive notice under subsection (c)” is good against a “later transfer.”³³ In order for a security agreement to provide “constructive notice” under section 205(c) (1) the recorded document must “specifically” identify the copyrighted work so that it can be revealed to a reasonable searcher by title or registration number, and (2) the work must have been registered.³⁴ Because this definition of “constructive notice”

²⁹ 116 B.R. at 203.

³⁰ U.C.C. § 9-204.

³¹ 17 U.S.C. § 205(a) (1994).

³² *Id.*

³³ 17 U.S.C. § 205(a) (1994).

³⁴ “...(2) registration *has been made* for the work.” 17 U.S.C. § 205(c)(2) (1994) (Emphasis

requires some prior specific identification of the work transferred by the recorded document, in addition to registration of the work, an effective Copyright Act recording cannot effectively reach after-acquired property.³⁵ If, under *Peregrine*, "federal law (the Copyright Act) preempts state *methods of perfecting* security interests in copyrights and related accounts receivable,"³⁶ then *all* the notice filing *methods of perfection* in Article Nine must yield to the transaction-specific rules of the Copyright Act. The *Peregrine* view of preemption makes the debt financing of "works in process," a movie in production for example, an intolerable legal gamble for the secured party.³⁷ Unless the secured party requires the debtor to capture the unfinished collateral project in a sequence of titled "works" which can be separately named, registered, and transferred in a series of recordable documents, the recording provision of the Copyright Act provides no "constructive notice" protection.

The connection between registration and recording may even turn out to be time-sensitive, similar to the manner of real estate recording. While a specific identification of the work *in the recorded instrument* is necessary for an effective Copyright Act recording of a security interest, it is not clear whether the essential section 205(c) *registration* of the copyright must precede the recording in order for the recording to be effective "constructive notice." The critical language of section 205(c)(2) states that "recordation . . . gives . . . constructive notice . . . but only if . . . (2) recordation *has been made* for the work."³⁸ Under section 205(c)(2) the order in which registration and filing of a security interest occur is critical to enforcement of the rights which one seeks to protect. Registration, at some point in time, is clearly necessary to provide "constructive notice." Furthermore, if the phrase "has been made" in section 205(c)(2) looks back from the date of recording, then a recorded security agreement would *never* be effective as constructive notice unless *preceded* in time by an effective registration of the work.

added.).

³⁵ 17 U.S.C. § 205(c)&(d) (1994). Economically significant financing today tends to be ongoing and fluid, not discrete. In ongoing financing, the transactional approach involves considerably more expense than the notice filing approach because the transactional approach involves multiple trips to the filing office, while notice filing requires only one. .

³⁶ 116 B.R. at 199.

³⁷ See Steven Weinberger, *Perfection of Security Interests in Copyrights: The Peregrine Effect on the Orion Pictures Plan of Reorganization*, 11 CARDOZO ARTS & ENT. L.J. 959, 975 (1993). (lending banks unable to properly perfect their security interests in the debtor's unreleased films because the films had not been registered within the meaning of section 205(c) of the Copyright Act).

³⁸ 17 U.S.C. § 205(c)(2) (1994) (emphasis added).

However, if "has been made" merely looks back from the date when the recording is effective as constructive notice or from the time the constructive notice issue becomes relevant, a recording prior to registration would be effective as long as the work is eventually registered. In such a case, however, the recorded document would only be effective as "constructive notice" under subsection (d) from the time the work was "registered."

The Bankruptcy Court that was overruled by the District Court in *Peregrine* subsequently described the controlling federal system for recording copyrights as one "modeled on real property recording acts."³⁹ Dicta from that Court's opinion in *In re AEG Acquisitions Corp.* suggests that recordation of a copyright mortgage 14 days before the registration of the underlying copyright might render the recordation invalid because it would be outside the "chain of title."⁴⁰ *In re AEG* seems to prefer a literal chronological reading of section 205(c)(2) - a reading which invalidates any recording not preceded in time by a registration. This chronological reading of section 205(c)(2) may not be compelled by the present language, however.

Even where there is an effective *prior* registration of the work, a recording might be outside the chain of title if one or more of the prior transfers leading to the debtor's title remains unrecorded or was not recorded in the proper order. Nothing in section 205(c) requires such a chronological reading of the constructive notice requirement and, in general, copyright law requires only the recording of *the* transfer, which shows the transferee's ownership rights.⁴¹ Unlike real estate law, the Copyright Act does not seem to expose the transferee of a *registered* copyright, who records outside the title chain, to the risk of losing priority to a purchaser who does not locate the copyright transferee's interest.⁴² Nevertheless, a security interest in a copyright may be enough of a derivative right to suggest that transfers necessary to locate ownership in the *immediate debtor* must be recorded before a security interest is effective as constructive notice or is properly perfected.

³⁹ *In re AEG Acquisitions Corp.*, 127 B.R. 34, 41 at n.8 (Bankr. C.D. Cal. 1991), *aff'd*, 161 B.R. 50 (9th Cir. B.A.P. 1993). Two of the works used as collateral in *AEG* were foreign films. Since the 1988 Amendments to the Copyright Act, registration has not been a prerequisite to maintaining an infringement action on a Berne Convention work. 17 U.S.C. § 411(a) (1994). The 1988 Amendments pertain only to infringement suit prerequisites, however; the amendments did not dispense with registration as a condition for constructive notice of a recorded transfer. 127 B.R. at 42; 161 B.R. at 57.

⁴⁰ 127 B.R. at 41 n.8. *But see* *Sevarouski Am., Ltd. v. Silver Deer, Ltd.*, 537 F. Supp. 1201 (D. D.C. 1982). *Sevarouski* involved the state of record title necessary to support an infringement action.

⁴¹ 3 NIMMER ON COPYRIGHT, § 12.02 at 12-59 & 12-60 (1993).

⁴² 537 F. Supp. at 1204.

In 1993, Congress considered eliminating the requirement of registration as a constructive notice condition under section 205(c).⁴³ The proposed Copyright Reform Act of 1993 would have provided constructive notice stature to documents which "identify the work . . . so that it would be revealed by a reasonable search under the title *or* registration number"⁴⁴ However, the Reform Act did not allow for the effective recording of agreements covering after-acquired property, since the recorded document still had to "identify the work." The Reform Act passed in the House of Representatives in late 1993, but failed to win approval in the Senate.⁴⁵

As long as identification of the debtor's intellectual property right is critical to an *effective* recording under section 205, a cautious lender should not rely simply on filing a security interest in the Copyright Office unless the copyright is registered. It would be prudent for the lender to ensure that the record contains any other transfer document necessary to establish the immediate debtor's ownership.

A further practical problem relates to the gap in time between the "date of recordation" of a security interest filed at the Copyright Office and the date on which the document is available for public viewing. The *date of recordation* is the date when the document in proper form is *received* in the Copyright Office.⁴⁶ "Recorded" documents are examined, numbered, scheduled and cataloged before they are made available for the public record. Prior to January 1994, the Copyright Office recording backlog averaged about eight months from the time the document was received. Currently, this "office delay" is an average of six months.⁴⁷ When this "office delay" is added to the 30-day look-back period, extending credit on the strength of a copyright becomes a time-consuming process. The secured party will not advance funds until the file is clear of possible assignees or secured parties who could claim a prior execution and recording within the grace period. Because recording dates from *receipt* of the recordable document in the Copyright Office, the file cannot be considered clear until the grace period and the "office delay" period have both passed. The language in section 205(a) of the Copyright Act, which links the importance of registration and a recording "in a manner required to give constructive notice," is the basis for

⁴³ The Copyright Reform Act of 1993, S. 373, 103rd Cong., 1st Sess. § 105(b) (1994).

⁴⁴ *Id.* (Emphasis added).

⁴⁵ 139 Cong. Rec. H 10308 (November 20, 1993).

⁴⁶ 37 C.F.R. § 201.4(e), § 201.25(e), §201.26(f). *See also* Copyright Office Circular # 12, *supra* at note 393. *But see* 3 NIMMER ON COPYRIGHT, § 10.07[A][1] at n.5 and Patch Factory, Inc. v. Broder, 586 F. Supp. 132 (N.D. Ga. 1984).

⁴⁷ Conversation between the author and Ms. Maria L. Llacuna, Copyright Document Specialist, Copyright Office, Library of Congress, Washington, D.C. (February 3, 2000).

an argument that Article Nine is not preempted with respect to unregistered copyrights.⁴⁸ However, because *Peregrine* concluded that the priority rules in Article Nine are preempted by section 205(d), and subsection (d) applies to all transfers of copyright ownership, registered and unregistered, that are included in subsection (a), the argument runs counter to the preemption doctrine as articulated by the Central District of California Court.⁴⁹ In any case, given the broad preemptive effect of section 205(a),⁵⁰ the constructive notice standard in subsection (c) will probably be seen as part of the *recording requirements* for all copyrights, not a limitation on the reach of preemption. Indeed, the Bankruptcy Court for the District of Arizona has rejected the registered-unregistered distinction in an opinion that adopts only a partial step-back for Copyright recording.⁵¹

E. *Peregrine and Priority*

The limitations on security interests inherent in the section 205 recording scheme are exaggerated when the priority rules in subsections (d) and (e) are applied to secured party conflicts. The single transaction structure, the long look-back period, and the built-in office delay that characterize Copyright Office recording all work mischief in the operation of the priority rule contained in section 205(d). First, section 205(d) has a very different set of axioms for "transfers of copyright ownership" than those provided for security interests in Article Nine. The first transfer *executed*, rather than the first to file, has priority under the Copyright Act as long as "constructive notice" of the transfer is given through a Copyright Office recording within one month of its execution in the United States, two months of its execution outside the United States, or at any time prior to a later competing transfer.⁵² Otherwise, the later transfer has priority under the Copyright Act if it is recorded first in a manner sufficient to give constructive notice,⁵³ and if such transferee takes (1) in good faith, (2) for

⁴⁸ A. Haemmerli, *Insecurity Interests: Where Intellectual Property and Commercial Law Collide*, 96 COL. L.REV. 1645, 1667-68 (1996).

⁴⁹ See *Maljack Productions, Inc. v. GoodTimes Home Video Corp.*, 81 F.3d 881, 888 (9th Cir. 1996).

⁵⁰ 17 U.S.C. § 205(a) (1994) ("Any transfer of copyright ownership or other document pertaining to a copyright may be recorded in the Copyright Office....").

⁵¹ *In re Avalon Software, Inc.*, 209 B.R. 517, 522-23 (Bankr. D.Ariz. 1997). However, *Avalon Software* views the constructive notice language in section 205(c) as part of the filing, not priority, provisions of the Copyright Act. See discussion in THOMAS M. WARD, *INTELLECTUAL PROPERTY IN COMMERCE*, § 2:81 (2000).

⁵² 17 U.S.C. § 205(d) (1994).

valuable consideration, and (3) without notice of the earlier transfer.⁵⁴

If the first secured party is also the first transferee from the debtor-owner, the secured party has priority over all "conflicting transfers" as long as the security agreement is recorded in the Copyright Office within 30 days or 60 days of its execution, as appropriate. However, because the recorded secured party can never be sure of the that it is the first transfer, the subsection (d) look-back compels lenders to record and then wait out a hypothetical prior party's "grace period" and the "office delay period" between receipt of the hypothetical prior party's document and its inclusion in the record.⁵⁵ The secured party's commitment to loan in the security agreement must be conditioned on a clean file after these periods have expired.⁵⁶

The race-notice character of the section 205(d) priority rule and the limitations imposed on the "between two transfer" scope make its application awkward when the rights of successive secured parties must be sorted out. Anytime more than two conflicting transfers are involved, the section 205(d) rule can produce a circular priority problem.⁵⁷

⁵³ The requirement that the subsequent transferee record "in such manner" obviously refers only to the manner required to give constructive notice under subsection (c), but not to the 30-day or 60-day grace period. See 3 NIMMER ON COPYRIGHT, § 10.07[A][4] at 10-58 to 10-59 (1993).

⁵⁴ 17 U.S.C. § 205(d)&(e) (1994); 537 F. Supp. at 1203, 1204. When both transfers are unrecorded, the first to execute seems to prevail under section 205(d) because the preemptive priority of the second transfer is dependent on recording.

⁵⁵ To the grace period (30 or 60 days), the secured party must add the "office delay" between copyright "recordation" and the date on which the transfer document is actually viewable. See *supra* text accompanying notes 686-688. Assume that the debtor executes a security transfer to the secured party on June 2. If that document, in proper form, is received in the Copyright Office on that same date, it will have a June 2 recording date as well. However, if a conflicting transfer was executed by the debtor on June 1, the earlier transferee will have priority over the secured party as long as the earlier transferee records (document received in the Copyright Office) by July 1. However, because that recording may not be known to the secured party until it appears on microfilm (one or two months later) the secured party should not disburse funds or release goods until that additional time beyond July 1 has passed.

⁵⁶ Subsequent transfers are protected if they are "for a valuable consideration." 17 U.S.C. § 205(d) (1994).

⁵⁷ The following fact pattern illustrates circular priority under section 205(d):

- (1) On June 1, Copyright Owner executes security interest transfer to X.
- (2) On June 10, Copyright Owner executes security interest transfer to Y.
- (3) On June 15, Copyright Owner executes security interest transfer to Z.
- (4) On June 30, Z records in the Copyright Office.
- (5) On July 5, X records in the Copyright Office.

The subsection (d) priority rule is double-qualified in a way that makes it unclear who the winner is when the prior transfer does not make a timely recording and, at the same time, the later transfer fails to meet the BFP-like statutory qualifications. Whenever a prior executed interest fails to record within the 30-day period (or 60-day period), a subsequent security interest must record first and take in "good faith" and "without notice" to qualify for priority under the last sentence of section 205(d). It is unclear what the section provides when the first transfer fails to record within the grace period and the later transfer records first but does not take in good faith or without notice. The later transfer does not qualify under the "prevails" mandate of the last sentence, but the earlier transfer does not qualify under the rule protecting the first to execute, either. To "prevail," the first executed transfer must either record within 30 days or "before . . . the later transfer."

The same problem arises whenever the later transfer is not taken for valuable consideration. When the competing transfers are *security interests*, the "without notice" and "for valuable consideration" conditions in the last sentence of section 205(d) create a very different priority scheme from the pure race provisions which control in contests between secured parties under Article Nine. The cases under the Copyright Act seem to hold subsequent transferees to a fairly rigorous inquiry obligation as part of the subsection (d) "without notice" standard.⁵⁸

The "valuable consideration" requirement in subsection (d) adds the further condition of either a present payment or an absolute obligation incurred by the "later transfer" at the time of such transfer.⁵⁹ The "binding promise to pay royalties" language was added as a qualifying "value" option in 1976 because conditional obligations that were not in fact executed or absolute did not satisfy the 1909 Act's definition of valuable consideration.⁶⁰ It is unclear how the "valuable consideration" qualification will be applied to subsequent secured parties under the priority scheme mandated by *Peregrine*. The "value" requirement for secured parties under Article Nine is

(6) On July 8, Y records in the Copyright Office. In this example, if we assume that Y and Z took their interests in good faith, without notice and for valuable consideration: X has priority over Y because, although X did not record within the 30-day grace period, X's interest was executed first and X filed before Y. Y has priority over Z because, *between the two*, Y executed first and recorded within the 30-day grace period. Z, the last to execute, has priority over X, the first to execute, because X failed to record within the 30-day grace period and, between the two of them, Z won the race to the Copyright Office. The result does not change if some or all of the transfers in the example are assignments or exclusive licenses rather than transfers for security.

⁵⁸ 3 NIMMER ON COPYRIGHT, § 10.07[A][2] at 10-54 to 10-56 (1993).

⁵⁹ 3 NIMMER ON COPYRIGHT, § 10.07[A][3] at 10-56 (1993).

⁶⁰ *Id.*

satisfied whenever the security interest is taken for an antecedent debt.⁶¹ *Peregrine* notwithstanding,⁶² the transfer of a security interest in a copyright to secure an antecedent debt *would not* be taken for a "valuable consideration" under section 205(d) of the Copyright Act.⁶³ It appears that a subsequent secured party who did not give "new value" would never be able to trump a prior transfer, including a prior secured party, even when that prior transfer is never recorded.⁶⁴ The best argument available to a subsequent secured party who took the interest for an antecedent debt is that once the subsequent interest is recorded in the Copyright Office before the prior transfer, the priority contest becomes a tie because the prior transfer seems to lose its argument for priority when it loses the race to record after the grace period has expired.⁶⁵ However, in the case of such a stalemate, the Court may go outside the recording statute and award priority to the first to execute.⁶⁶

The priority rule covering priority between a transfer of copyright ownership and a nonexclusive licensee in section 205(e) can be a trap for the secured party as well. Under *Peregrine*, if a security interest in a copyright is indeed a "transfer of copyright ownership," then the priority between such a security interest and a nonexclusive license is controlled by section 205(e) of the Copyright Act. Under subsection (e), the licensee prevails if the license is evidenced by a signed instrument and is either: 1) taken before the execution of the security agreement, or 2) taken after an unrecorded security transfer, if the licensee takes in good faith and without knowledge.⁶⁷ Unlike

⁶¹ U.C.C. § 9-203(1)(b) & § 1-201(44).

⁶² Recall that the *Peregrine* Court concludes that the hypothetical lien creditor under section 544(a) of the Bankruptcy Code draws rights from section 205(d) of the Copyright Act because such a lien creditor can be "deemed" a *transfer taken for valuable consideration*. 116 B.R. at 207. Such "deeming" is made possible by the statutory characterization of the hypothetical lien creditor in section 544(a)(1) as one who "extends credit" and "obtains ... a judicial lien simultaneously at the 'commencement of the case.'" 11 U.S.C. § 544(a)(1). See discussion *supra* Section III(b)(3)(B). In dicta, the Court also notes that the lien of a judgment creditor "is deemed to be in exchange for the claim that formed the basis of the underlying judgment, a claim that is extinguished by the entry of the judgment." This reasoning is suspect. The judgment creditor's claim may merge in the judgment but that does not provide the lien with "for value" status. Under that logic, all judgment creditors might claim their liens were obtained for new value.

⁶³ 17 U.S.C. § 205(d) (1994).

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ See *Ice Music, Ltd. v. Schuler*, 42 U.S.P.Q.2d 1449, 1454 (U.S.D.Ct. S.D.N.Y. 1996)(Under section 205(e), "[assignor] was not 'the owner of the rights licensed' at the time [nonexclusive licensee] allegedly received money and ... signed the Receipt....")

⁶⁷ 17 U.S.C. § 205(e) (1994).

the secured party, the nonexclusive license is *not* a transfer of copyright ownership that invokes the writing requirement in section 204 of the Copyright Act.⁶⁸ Therefore, an oral transfer of a nonexclusive license is effective.⁶⁹ However, for such a nonexclusive license to have priority over subsequent "ownership" transfers as well as prior unrecorded "ownership" transfers, it must be evidenced by a signed writing.⁷⁰ While section 205(e) does not expressly date the nonexclusive license by the date of the evidencing writing, there is case law to that effect.

In *Ice Music, Ltd. v. Schuler*⁷¹ the United States District Court for the Southern District of New York held that the execution of the necessary writing evidencing the nonexclusive license must precede the ownership transfer under 205(e)(1).⁷² If a prior oral license loses to a competing ownership transfer at the time of transfer, a subsequent nonexclusive BFP licensee would seem to suffer the same fate if the writing requirement is not satisfied when the prior transfer is recorded under section 205(e)(2).

As explained in Part II(e)(2)(B), Revised Article Nine makes express provision under state law for the priority of a security interest as against conflicting licensees from the debtor licensor. Three principal priority rules for secured parties and licensees can be derived from the Revisions:

1. A subsequent licensee prevails over any prior secured party to the extent that the license was a disposition authorized free and clear of the security interest.⁷³ Furthermore, the Revised definition of "proceeds"⁷⁴ indicates that even a nonexclusive

⁶⁸ 17 U.S.C. § 101, "transfer of copyright ownership" (1994); 17 U.S.C. § 204 (1994).

⁶⁹ 3 NIMMER ON COPYRIGHT, § 10.02[B][5] at 10-25 (1993).

⁷⁰ 17 U.S.C. § 205(e) (1994). Section 205(e) works better than Article Nine when the nonexclusive license is a contingent one used to carry out the provisions of an escrow agreement covering copyrighted source code. The escrow agent holds the source code as security for the licensee against the licensor's performance of the main licensing agreement. If Article Nine applied, this security interest in a source code license might have to be filed as a "general intangible" in order to defeat a subsequent bankruptcy trustee. Under the preempting copyright rule in section 205(e), however, no filing or recording is necessary as long as it is a nonexclusive license in the source code that is conditionally available on default. Only a writing is required.

⁷¹ 42 U.S.P.Q.2d 1449 (U.S.D.Ct. S.D.N.Y. 1996).

⁷² 42 U.S.P.Q.2d at 1454 (Under section 205(e), "[assignor] was not 'the owner of the rights licensed' at the time [nonexclusive licensee] allegedly received money and ... signed the Receipt . . .")

⁷³ U.C.C. [Revised] § 9-315(a)(1).

⁷⁴ U.C.C. [Revised] § 9-102(a)(64)(A) ("whatever' is acquired upon the sale, lease, license, exchange, or other *disposition* of collateral ...") (Emphasis added).

license can qualify as an authorized *disposition*.⁷⁵

2. Even if the license is not authorized by the secured party, a subsequent nonexclusive licensee in the ordinary course of business takes free of the security interest even if the licensee is aware of the interest.⁷⁶
3. Even a subsequent licensee that does not take under an authorized license or under the ordinary course rule will prevail to the extent that it "gives value without knowledge of the security interest and before it is perfected."⁷⁷

Because *Peregrine* teaches that a security interest is a "transfer of copyright ownership,"⁷⁸ these rules appear to be currently displaced in favor of the priority scheme in section 205(e) of the Copyright Act.⁷⁹ Note that the proposed "Federal Intellectual Property Security Act,"⁸⁰ would remove the priority conflict between the secured party and the nonexclusive licensee from section 205(e) and make Article Nine applicable.⁸¹

In re Avalon Software, Inc.

A. The Avalon Holding

In a case decided seven years after the Arizona Bankruptcy Court, in *In re Avalon Software, Inc.*⁸² concluded that a reconciliation of the Copyright Act and Article Nine did not require complete preemption of Article Nine's priority rules. *Avalon Software* finds that the partial step-back under U.C.C.

⁷⁵ U.C.C. [Revised] § 9-315(a)(1).

⁷⁶ U.C.C. [Revised] § 9-321(a)&(b).

⁷⁷ U.C.C. [Revised] § 9-317(d).

⁷⁸ 17 U.S.C. 101 (1994).

⁷⁹ 116 B.R. at 205.

⁸⁰ Task Force on Security Interests in Intellectual Property, Business Law Section, American Bar Association, DRAFT, FEDERAL INTELLECTUAL PROPERTY SECURITY ACT (March 1, 1999)[hereinafter referred to as TASK FORCE DRAFT - FEDERAL INTELLECTUAL PROPERTY SECURITY ACT].

⁸¹ TASK FORCE DRAFT - FEDERAL INTELLECTUAL PROPERTY SECURITY ACT, *supra* note⁸⁰ at SECTION 4(a)(3).

⁸² 209 B.R. 517 (Bankr. D. Ariz. 1997).

section 9-302(3)(a) and (4) is more compatible with the scope of federal preemption. For the lending bank that failed to make any recording in the Copyright Office, however, the distinction between full and partial step-back was academic. The Court held that the bank's security interest in all the debtor's copyrighted and copyrightable software was unperfected on the date of the petition because it had not been recorded in the Copyright Office under section 205(a) of the Copyright Act.⁸³ However, after finding that the bank's filing of a U.C.C. financing statement left copyright collateral unperfected, the opinion departed from the complete preemption rationale of the *Peregrine* decision. Instead, *Avalon Software* relied on Article Nine section 9-301(1)(b) (not section 205(d) of the Copyright Act) for the proposition that an unperfected security interest is subordinate to the trustee asserting the rights of a hypothetical lien creditor.⁸⁴ In addition to recognizing the vitality of U.C.C. priority rules, the Court also concluded that the Article Nine concept of attachment was not preempted by the Copyright Act.⁸⁵

This more limited approach to preemption has its own problems. In essence, *Avalon Software* concludes that section 205(c)'s proviso on constructive notice (specific identification of the work in the recorded document and registration of the work) is part of the displacing *recording* requirements of the Copyright Act. Recall that the elements of constructive notice under section 205(c) are not actually required in order to make a subsection (a) recording.⁸⁶ These requirements arise only within the context of the Copyright Act's priority rule in section 205(d).⁸⁷ If, contrary to *Peregrine*, the priority rule in subsection (d) does not displace Article Nine priority provisions, it can be argued that constructive notice under subsection (c) should not be required if the security interest is otherwise properly recorded in the Copyright Office under section 205(a). Nevertheless, *Avalon Software* concludes that "ultimate perfection" depends upon registration of the software product.⁸⁸ The *Avalon Software* opinion sees registration as part

⁸³ *Id.* at 523-24.

⁸⁴ *Id.* at 521.

⁸⁵ *Id.* at 522-23.

⁸⁶ See discussion in PRELIMINARY REPORT #1, AN OVERVIEW OF THE CURRENT LEGAL RULES AND STRUCTURES GOVERNING THE PERFECTION AND PRIORITY OF THE SECURITY INTERESTS IN INTELLECTUAL PROPERTY AND AN ANALYSIS OF PROPOSED LEGISLATIVE REFORMS at Section III (b)(3)(D) (Cooperative Contract - U.S.P.T.O. and Franklin Pierce Law Center 2000).

⁸⁷ *Id.* It can even be argued that subsection (c)'s constructive notice requirement is not critical to a recording for purposes of the nonexclusive licensee rule in subsection section 205(e).

⁸⁸ 209 B.R. at 522. Recorded documents that could not be tied to an existing registration

of the secured party's U.C.C. section 9-302(4) "compliance" with the national recordation system that displaces Article Nine filing under section 9-302(3)(a).⁸⁹

This aspect of the partial step-back can be problematic. The relationship between Copyright Act recording, with its attendant registration requirement, and the controlling Article Nine rules on "attachment" is unclear when after-acquired copyright collateral is involved. According to *Avalon Software*, federal copyright law does not alter the secured party's right to acquire an interest in the debtor's after-acquired copyright collateral under an agreement executed before the debtor acquires rights in the collateral.⁹⁰ Even if an after-acquired property clause is effective to create an interest in the debtor's later-acquired copyrights, perfection requires compliance with section 205(d) and (c) of the Copyright Act.⁹¹ *Avalon Software* suggests that the secured party could have recorded a security agreement covering after-acquired copyright collateral and then, without the need of a further recorded document, been perfected in such later-acquired property by registering the new works as they came into existence.⁹²

However, constructive notice under subsection (c) requires more than a recorded document with advance notice of a security interest and a subsequent registration of the work. Subsection (c) requires that the recorded document, or material attached to it, *specifically identify the work to which it pertains*.⁹³ A document in the form of a security agreement covering after-acquired property could not satisfy the "specific identification" requirement as to copyright collateral subsequently acquired by the debtor. A subsequent registration of the new collateral does not cure the problem with the prior recorded security agreement.⁹⁴ Despite this confusing dicta in *Avalon Software*, a secured party who wants perfection in after-acquired property would be well advised to get the debtor to sign a new agreement that specifically identifies the new work, register the new work, and record the new agreement. While *Avalon Software's* partial step-back approach may cause less preemption mischief than *Peregrine*, clearly one of the

would be harder to find in a typical copyright search.

⁸⁹ 209 B.R. at 521. U.C.C. § 9-302(3)(a),(4)& cmt. 8.

⁹⁰ 209 B.R. at 522-23.

⁹¹ *Id.*

⁹² "If Imperial Bank had merely done what the law requires - that is, to record evidence of its security interest in the U.S. Office of Copyright - and had it made sure that the after-acquired property had been registered, it would have been found to be perfected." 209 B.R. at 523.

⁹³ 17 U.S.C. § 205(c) (1994).

⁹⁴ 17 U.S.C. § 205(c) (1994).

pitfalls is the meshing of the facile Article Nine law on subsequent attachment with single transaction document recording.

B. Avalon and the Definition of Collateral

While the Court in *Avalon Software* properly rejects the argument that unregistered copyrights are not within the scope of section 205,⁹⁵ the opinion goes too far in its holding that all *copyrightable* collateral must be recorded under the Copyright Act.⁹⁶ Under the current state of the law, copyrightable software that has its principal intrinsic value as a trademark or as a trade secret should be perfected by filing under the U.C.C.⁹⁷ even if it is also copyright protected. While the partial step-back approach seems more consistent with the intended scope of section 205 of the Copyright Act, it still requires that copyright collateral be distinguished from other valuable intangible rights in works that may qualify for more than one form of protection.⁹⁸

⁹⁵ 209 B.R. at 522-23.

⁹⁶ 209 B.R. at 523-24.

⁹⁷ Trade secret software fits the definition of a "general intangible" under section 9-106. See U.C.C. § 9-106.

⁹⁸ See discussion in PRELIMINARY REPORT #1, *supra* note 86 at Section VI(b). An argument against reform has been made by the Motion Picture Association of America. The M.P.A.A. position is discussed in PRELIMINARY REPORT #1, *supra* note 86 at footnote 754.

APPENDIX 16 - WORLD AUXILIARY POWER

Copyright Act Does Not Preempt When the Copyright is Unregistered

In December of 1999, the Bankruptcy Court for the Northern District of California Arizona, faced another perfection of copyright collateral issue under § 544(a) of the Bankruptcy Code. In the case of *In re World Auxiliary Power Co.*,¹ the debtor's collateral was its copyrights in drawings blueprints and related software and it was clear from the record that none of the copyright collateral was registered with the Copyright Office on the day that the bankruptcy petition was filed. As was the case in *Peregrine and Avalon Software*, the secured party made only an Article Nine filing—nothing was recorded under section 205 of the Copyright Act. Unlike *Peregrine and Avalon Software*, however, *World Auxiliary Power* held for the secured party on the theory that Article Nine is not preempted (to any extent) when the copyright collateral is unregistered. The court in *World Auxiliary Power* found that the *priority rule* in 205(d) has no application to unregistered copyrights because registration is one of the conditions necessary for “constructive notice” and constructive notice is a condition of recording priority. For good measure, the court also concluded that Copyright Act *recording* does not preempt Article Nine *filing* when the copyrights are not registered.²

The theory of *World Auxiliary Power* is that registration defines the reach of Copyright Act recording and priority. While *Peregrine* goes too far, and cutting unregistered copyrights out of its preemption holding seems like an appealing way to limit the decision, the distinction suggested by *World Auxiliary Power* does not pass careful logical scrutiny. If indeed section 205(d) provides recording and priority only for registered copyrights individual states could provide their own priority rules or even their own alternative recording acts aimed at ordering disputes in all copyright transfers (whether or not for security) as long as the copyrights remained unregistered. This seems clearly contrary to the inclusive language in section 205(a) of the Copyright Act setting out the range of transactions that are recordable. A fair reading of section 205 as a whole suggests that registration is merely a necessary condition for giving constructive notice of any transfer of copyright ownership, whether or not it is registered at the outset. Congress

¹ *In re World Auxiliary Power Co.*, 244 B.R. 149 (Bankr. N.D. Calif. 1999).

² 244 B.R. at 154-56.

must have intended section 205 to serve as the recording rule for all copyrights - both registered and unregistered.³

World Auxiliary Power supports the distinction on the premise that the *Peregrine* holding could not, as a technical matter, be extended to unregistered copyrights. The court opines that, unless the copyrights in *Peregrine* had been registered, the hypothetical lien creditor [trustee under 544(a)(1)] could not have claimed priority as a “later transfer” that must give “constructive notice” through section 205(d) of the Copyright Act.⁴

However, this argument does not credit either the range of ownership transferees who can register a copyright or the make-believe nature of the lien creditor as envisioned by *Peregrine*. In deciding that the lien creditor was a protected later transfer under section 205(d), the *Peregrine* court assumes the fact that a Copyright Office recording by the trustee had occurred.⁵ Of course, the bankruptcy trustee did not actually record anything. The recording was “hypothetical”—merely part of the assumed (some might say conjured) nature of the lien creditor constructed by § 544(a)(1) of the Bankruptcy Code. If registration is indeed a condition for effective recording of all copyrights, and not a limit on the reach of Copyright Act recording itself, the act of registering the copyright might also be assumed as part of the trustee’s fictitious § 544(a)(1) personality. As noted above, *Peregrine* seems to go too far when it includes the involuntary lien creditor in the class of protected “later transfers.”⁶ If, however, *Peregrine* is right on this score and the involuntary lien creditor finds shelter in section 205(d), then that same lien creditor would also seem to be vested with sufficient “copyright ownership” to allow it to register the work so acquired under section 408(a) of the Copyright Act.⁷ If a real lien creditor/transferee could register an unregistered copyright in order to give constructive notice of its recordable ownership interest under 205(a) and (c),

³ Note that section 205(a) provides that “[a]ny transfer of copyright ownership or other document pertaining to a copyright may be recorded in the copyright office” 17 U.S.C. § 205(a) (1994). The scope language *does not* limit the scope of Copyright Act recording to registered copyrights.

⁴ Unlike the Patent Act and the Lanham Trademark Act, a subsequent party does not prevail as a BFP under the Copyright Act unless it wins the race to the section 205 record and records in that record “in such manner [required to give constructive notice].” 17 U.S.C. § 205(d) (1994).

⁵ *National Peregrine, Inc. v. Capital Federal Savings & Loan Ass’n*, 116 B.R. 194, 207 (C.D. Cal. 1990).

⁶ See *supra* text accompanying notes 122 to 130.

⁷ 17 U.S.C. § 408(a) (1994) (“... the owner of a copyright or of any exclusive right in the work may obtain registration”).

then the hypothetical lien creditor under section 544(a)(1) of the Bankruptcy Code would clearly be able to assume as much as of the petition date.⁸

Finally, the result in *World Auxiliary Power* seems flawed even if one accepts the Court's questionable first holding that Copyright Act *priority* under the teaching of *Peregrine* is only extended to registered Copyrights. The Court's second, and severable, conclusion that Article Nine *filing* is not displaced by Copyright Act recording when the copyright is unregistered also requires some very heavy lifting. On this second point the Court merely refuses to be guided by the unequivocal reference to the Copyright Act as a displacing registry under old U.C.C. § 9-302(3)(a)&(4).⁹ It may be that intelligent speculation suggests that the drafters of old section 9-302 were not as familiar with the scope and mechanics of Copyright Act recording as they might have been. Nevertheless, the drafters clearly identified the 1909 Copyright Act as an example of a displacing registry and the 1976 amendments to the Copyright Act expanded the scope of this federal recording even further. It is hard to argue with partial preemption, extending only to Article Nine filing, where the authors of Article Nine themselves conclude that a state filing on copyright collateral would be ineffective because the proper recording locale is in Washington.

The language of Revised Article Nine would provide much more support for *World Auxiliary Power's* second conclusion that state law does not voluntarily yield its filing rules to the Copyright records. Under the Revision language (now applicable in California but not applicable under the facts of the case), eligibility for a filing deferral requires that the displacing federal statute have "requirements for a security interest's obtaining priority over the rights of a lien creditor"¹⁰ However, if we accept the most extreme teaching of *Peregrine* (as *World Auxiliary Power* purports to do) even this new U.C.C. language invites a deferral on state filing. Remember that *Peregrine* concludes that section 205(d) of the Copyright Act does contain a priority rule that embraces the lien creditor.¹¹

Peregrine justly deserves most of the criticism it gets. However, the limit on preemption suggested by *World Auxiliary Power* is a conceptual and statutory reach. Even if it can be justified as a matter of federal preemption, it protects state law filing only until someone with ownership rights registers the copyright (the debtor or any transferee or exclusive licensee). This questionable distinction based on whether or not copyright collateral is

⁸ 11 U.S.C. § 544(a)(1) (1998).

⁹ 244 B.R. at 154-56.

¹⁰ U.C.C. [Revised] § 9-311(a)(1).

¹¹ 116 B.R. at 203-04.

registered is anything but a safe harbor for the secured party contemplating a credit extension secured by copyright collateral.

APPENDIX 17 - THE HISTORY OF THE BFP RULE

The current language in section 261 of the Patent Act has roots in the patent legislation of the nineteenth century. The Patent Act of 1870 provided in part: "That every patent or any interest therein shall be assignable in law, by an instrument in writing; and the patentee or his assigns or legal representatives may, in like manner, grant and convey an exclusive right under his patent to the whole or any specified part of the United States, and said assignment, grant, or conveyance shall be void as against any subsequent purchaser or mortgagee for valuable consideration, without notice, unless it is recorded in the patent office within three months from the date thereof."¹

Because patents have always had the attributes of personal property, Courts before and since 1870 have recognized and applied a common law bona fide purchaser for value rule to protect subsequent patents transferees. Under this venerable rule: "when a legal title holder of a patent transfers his or her title to a third party purchaser for value without notice of an outstanding *equitable claim or title*, the purchaser takes the entire ownership of the patent, free of any prior *equitable encumbrance*."²

One example of an "equitable encumbrance" that is cut off under the common law rule would be the prior assignor's right to have the assignment rescinded for fraud, thereby recovering legal title from the assignee.³ The right of a party with a present contract right to compel an assignment, as distinguished from a present assignment, is another judicially recognized example of an equitable encumbrance on a patent.⁴ Even before the first Patent Act provision compelling recording, a bona fide purchaser had the

¹ The Patent Act of 1870, ch. 230, 16 Stat. 198-217 (1870), *amended and now codified at*, 35 U.S.C. § 261 (1994).

² *FilmTec Corp. v. Allied-Signal, Inc.*, 939 F.2d 1568, 1573 (Fed. Cir. 1991)(Emphasis added.). *FilmTec* cites to the *Hendrie v. Sayles*, [98 U.S. 546, 549 (1879)] for the proposition that a prior equitable encumbrance is cut off by a bona fide purchaser. 939 F.2d at 1537. The Federal Circuit recently applied the same common law bona fide purchaser rule to protect an exclusive licensee in *Heidelberg Harris, Inc. v. Loebach*, 1998 U.S. App. LEXIS 11490 at *10-11, 46 U.S.P.Q.2d 1948 (Fed. Cir. 1998).

³ 1998 U.S. App. LEXIS 11490 at *10-11.

⁴ A *present agreement to assign* future inventions (as distinguished from a *present assignment* of future inventions) vests equitable, not legal, title in the assignee. *Arachnid, Inc. v. Merit Indus., Inc.*, 939 F.2d 1574, 1580-81 (Fed. Cir. 1991). Contrast *Arachnid* with *FilmTec Corp. v. Allied-Signal, Inc.*, 939 F.2d 1568, 1573 (Fed. Cir. 1991)(A *present assignment* of future rights vests legal title as soon as the patent or the application come into existence.).

right to trump these "equitable encumbrances." This common law right existed outside the scope of the first Patent Act recording provision and such right still exists outside the scope of its direct descendent, present section 261.⁵ However, the statutory recording scheme adds another element to the protection afforded bona fide purchasers under the common law BFP rule. Section 261, in the manner of its early predecessor, "goes a step further" because it protects bona fide purchasers against prior *legal* interests that are not properly recorded.⁶ When the forerunner of the present patent recording statute was enacted, and then later amended, the chattel mortgage was viewed as a transfer of legal title.⁷ Historically, the chattel mortgage on personality depended on the movement of title to the mortgagee for its conceptual validity.⁸ Because the chattel mortgage was a title transfer by definition, a bona fide purchaser who sought protection from a prior unrecorded mortgage looked to the recording statute, which extended to unrecorded legal title transfers, for that protection.⁹

⁵ *Hendrie v. Sayles*, 98 U.S. 546, 549 (1879); 939 F.2d at 1573 (prior equitable encumbrance cut off by a bona fide purchaser under separate common law principles).

⁶ 939 F.2d at 1573.

⁷ 1 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 1.1 at 5&8, (1965).

⁸ 1 G. GILMORE, *supra* note 7, § 1.1 at 8 n.11.

⁹ *Waterman v. Mackenzie*, 138 U.S. 252, 256 (1890).

APPENDIX 18 - SECTION 261 THEORIES OF DISPLACEMENT

Section 261 of the Patent Act can be read to displace all or part of Article Nine under one of three theories. First, if a title transfer is considered a necessary *federal incident* to the creation of a security interest in a patent, in some or all cases, the federal title model may preempt the title neutral concept in Article Nine.¹ Second, a security interest is a protected "purchaser or mortgagee" under section 261, thus giving subsequent secured parties rights against unrecorded patent transferees that they do not enjoy under Article Nine.² Finally, the common law BFP rule (outside section 261) that protects "purchasers" who take legal title to a patent against *equitable* encumbrances is, in fact, federal common law that was never altered by Article Nine's enactment in the various states.³

A. *Preemption and Unrecorded Assignments under the Patent Act*

Whether the Article Nine security interest is an assignment, grant or conveyance that needs to be recorded under section 261, if the security interest is a protected subsequent party, Article Nine's priority rule will yield to the Patent Act anytime a transfer intended for security follows an unrecorded assignment.

This hypothetical involving a priority dispute between a prior unconditional assignee and a subsequent secured party makes the strongest case for the partial preemption of Article Nine.⁴ Section 261 provides that if a patent assignee does not make a proper PTO recording within three months of the executed assignment or prior to the date of any subsequent purchase or mortgage, the assignment is "void" against the subsequent bona fide "purchaser or mortgagee."⁵ Thus, the negative inference under patent law is that the assignee has better rights in the patent than the subsequent purchaser or mortgagee if the assignment is filed first or within three months of its

¹ See discussion PRELIMINARY REPORT #1: AN OVERVIEW OF THE CURRENT LEGAL RULES AND STRUCTURES GOVERNING THE PERFECTION AND PROPERTY OF SECURITY INTERESTS IN INTELLECTUAL PROPERTY AND AN ANALYSIS OF PROPOSED LEGISLATIVE REFORMS at Section III (C)(3) et seq. (Cooperative Contract - U.S.P.T.O. and Franklin Pierce Law Center 2000).

² See discussion in PRELIMINARY REPORT #1, *supra* note 1 at Section III(c)(4).

³ See discussion in PRELIMINARY REPORT #1, *supra* note 1 at Section III(c)(5).

⁴ 35 U.S.C. § 261 (1994).

⁵ *Id.*

execution.⁶ In the case of the prior assignee matched against a subsequent secured party, the prior assignee is squarely within the prior section 261 "assignment, grant or conveyance."⁷ If the secured party is a protected section 261 "subsequent purchaser or mortgagee" as well, then inconsistent Article Nine provisions will yield to section 261 of the Patent Act every time the conflict is so formed. Recent section 261 case law concludes that the "purchaser" protected under section 261 is the same "purchaser" protected under the common law bona fide purchaser rule applied to patents.⁸ As noted earlier in section III(c)(1)(B), the Federal Circuit has recently used the common law bona fide "purchaser" rule to protect an exclusive licensee who took from the legal title holder in a transaction under which the licensor was found to have "retained ownership."⁹ While a third party who takes an interest in less than the exclusive right to make, use and sell may not be protected,¹⁰ a consensual lien on the whole patent would seem to be sufficient as long as a protected "purchaser" does not have to take ownership.¹¹ A secured party will qualify as a protected subsequent "purchaser" under section 261 if the statutory rule covers the same ground as the common law BFP rule applied by the Federal Circuit.¹² As for current state law, a secured party falls within the U.C.C. definition of a "purchaser" in sections 1-201(32)&(33).¹³ If the section 261 reference to a subsequent "purchaser or mortgagee" mimics the common law BFP,¹⁴ the reference may not be as title-sensitive as the "assignment, grant or conveyance" language that measures the recording mandate of the same section.¹⁵ In other words, a secured party

⁶ Why Corp. v. Super Ironer Corp., 128 F.2d 539, 53 U.S.P.Q. 609 (6th Cir. 1942).

⁷ 35 U.S.C. § 261 (1994).

⁸ Heidelberg Harris, Inc. v. Loebach, 1998 U.S. App. LEXIS 11490 at *10-11 (Fed. Cir. June 2, 1998)("...one who acquires an interest in a patent for valuable consideration from the legal title holder..."); FilmTec Corp. v. Allied-Signal, Inc., 939 F.2d 1568, 1573 (Fed. Cir. 1991)("Both the common law rule and the statute [§ 261] contemplate that the subsequent purchaser be exactly that - a transferee who pays valuable consideration, and is without notice of the prior transfer.")(Emphasis and brackets added.).

⁹ 1998 U.S. App. LEXIS 11490 at *2-3.

¹⁰ Weiner v. Rollform, Inc., 774 F.2d 797, 807 (Fed. Cir. 1984); Bailey v. Chattem, Inc., 684 F.2d 386, 392 (6th Cir. 1982)

¹¹ 1998 U.S. App. LEXIS 11490 at *2-3 & *10-11 (Harris was a bona fide purchaser for value of an exclusive conditional license to make use and sell.).

¹² *Id.*

¹³ U.C.C. § 1-201(32)&(33). Revised Article Nine is even more specific. U.C.C. [Revised] § 1-201(32)&(33)("security interest" specifically included).

¹⁴ 939 F.2d at 1573.

¹⁵ See discussion in PRELIMINARY REPORT #1, *supra* note 1 at Section III(c)(1)(C).

seems to qualify as a protected "purchaser" under section 261 of the Patent Act whether the security interest is itself an "assignment, grant or conveyance" that must record or risk avoidance.¹⁶

If the language "subsequent purchaser or mortgagee" in section 261 refers only to the title-bearing mortgagee ancestors of the Article Nine security interest, as some have argued, the recording provisions of section 261 do not preempt Article Nine.¹⁷ If a secured party is a "subsequent purchaser or mortgagee," the applicable section 261 priority rule conflicts with the Article Nine priority provision in section 9-301(1)(d). Article Nine section 9-301(1)(d) provides that an unperfected security interest in general intangibles is subordinate to the right of a transferee who gives value for the rights without knowledge of the unperfected security interest therein.¹⁸

Assuming that U.C.C. section 9-301(1)(d) applies to potential security interests because that do not exist, as well as those that exist but remain unperfected,¹⁹ then state law would award priority to the prior executed assignee whether or not the assignee filed with the PTO.²⁰ Again, under section 261, the secured party would win if the prior assignee failed to record with the PTO prior to the date of the security agreement, or within three months of the executed assignment.²¹ Section 261 should displace the Article Nine priority rule in section 9-301(1)(d) in the case of a prior assignee and subsequent secured party.

1. Non-Statutory Federal BFP

As noted earlier, an Article Nine "security interest" can be viewed as a contingent agreement to assign in the future and thus transfers equitable title to the secured party.²² If a security agreement does create equitable title

¹⁶ 35 U.S.C. § 261 (1994).

¹⁷ If the secured party must qualify as a subsequent "mortgagee," and that word retains its pre-U.C.C. "title" armor, then the protected interests described in section 261 do not include the Article Nine security interest.

¹⁸ U.C.C. § 9-301(d).

¹⁹ The controversy concerning the scope of Article Nine's third-party priority rules is discussed in PRELIMINARY REPORT #1, *supra* note 1 at Section II(e)(2)(B) et seq.

²⁰ See U.C.C. § 9-301(1)(d) ("a person who is ... a transferee"). See also U.C.C. [Revised] § 9-317(d).

²¹ 35 U.S.C. § 261 (1994).

²² Note, *Recording Security Interests in Patents: Accepting A Traditional Federal System To Preserve the Policies Of Patent Law*, 2 B.U.J.SCI.&TECH.L. 15 para. 34 & 35 (1996). A present agreement to assign future inventions (as distinguished from a present assignment of future inventions) vests equitable, not legal, title in the assignee.

in the secured party, then under common law principles applied in patent cases a bona fide purchaser of rights from the legal title holder without notice, cuts off the equitable title.²³ If this bona fide purchaser rule survives as some form of "federal common law," then an argument for preemption exists, even if security interests do not fall within the "assignment, grant or conveyance" language of section 261 of the Patent Act.²⁴ However, recent Federal Circuit Court cases seem to trace this common law bona fide purchaser principle to state law as it is applied to the transfer of federally created property.²⁵ Old state common law governing bona fide purchasers in conflict with the equity of secured parties has yielded to Article Nine.²⁶ Under Article Nine the BFP, without actual or inquiry notice, still could not cut off the secured party's right if the secured party properly filed under Article Nine.²⁷

2. Priority

a) Scope of Patent Act Priority Language

Because the rule appears to exclude involuntary transfers, including the judicial lien creditor, only two possible priority conflicts might fall within its language. As some of the case law has suggested, the language can be read to control some or all of the conflicts between security interests in patent rights and assignments of those same rights. If the security interest transfer itself is viewed as "an assignment, grant or conveyance, then the section 261 priority rule might be construed to cover conflicts between secured parties when patent rights are the subject collateral.

Arachnid, Inc. v. Merit Indus., Inc., 939 F.2d 1574, 1580-81 (Fed. Cir. 1991). A prior assignor with the right to have the assignment rescinded for fraud has equitable, not legal, title prior to the actual court ordered rescission. *Heidelberg Harris, Inc. v. Loebach*, 1998 U.S. App. LEXIS 11490 at *10-11, 46 U.S.P.Q.2d 1948 (Fed. Cir. 1998).

²³ 1998 U.S. App. LEXIS 11490 at *10-11; *FilmTec Corp. v. Allied-Signal, Inc.*, 939 F.2d 1568, 1573 (Fed. Cir. 1991).

²⁴ 35 U.S.C. § 261 (1994).

²⁵ The *FilmTec* Cir. Court cites to *Hendrie v. Sayles*, [98 U.S. 546, 549 (1879)] for the proposition that a prior equitable encumbrance is cut off by a bona fide purchaser. See 939 F.2d 1568 at 1537. *Heidelberg Harris, Inc.* in turn relies on *FilmTec*. i.e. 1998 U.S. App. LEXIS 11490 at *10. The Supreme Court's pre-Erie decision in *Hendrie v. Sayles* relies on state law principles of derivative title and bona fide purchaser status rather than any uniquely federal policy. See 98 U.S. 546 at 551-52. See also *In re CFLC, Inc.*, 89 F.3d 673, 678-79 (applies federal common law where it is important to preserve federal patent policy).

²⁶ U.C.C. § 9-203, cmt. 5.

²⁷ U.C.C. § 9-301(1)(d). *Accord* U.C.C. [Revised] § 9-317(d).

b) Secured Party vs. Assignee

Even if the security interest transfer is not an assignment, grant or conveyance that must be recorded under section 261, a subsequent secured party has a strong claim to the status of a "subsequent purchaser or mortgagee" who *may* be protected against prior assignments that must record within three months of execution.²⁸ This section 261 protection for the Article Nine secured party comes with several qualifying limitations.

First, in order to have priority, the later security interest must be "without notice" and "for valuable consideration."²⁹ The "valuable consideration" requirement has already been discussed in the context of the Copyright Act limits on the protection against unrecorded transfers afforded to subsequent interests.³⁰ A subsequent security interest taken to secure an antecedent debt may not qualify. A second hurdle to the subsequent secured party's priority is the "without notice" requirement in section 261. The "notice" referred to in section 261 is broader than actual notice. As it includes constructive and inquiry notice as well.³¹

Whenever a prior assignee does not record within the three-month period, the BFP secured party has priority as long as the security agreement attaches before any late recording by the assignee. Unlike under section 205(d) of the Copyright Act, recording is not relevant to the subsequent party's section 261 rights against a prior unrecorded assignment.³²

Even when the subsequent secured party gives new value and cannot be chargeable with notice, section 261 presents major problems as a priority rule. Because of the three-month look-back any secured party is vulnerable to a potential prior unrecorded assignment for that time. As further complication assignments sent to the PTO are deemed "recorded" under section 261 from the time of "receipt," not from the time they are available for inspection.³³ The "office delay" which occurs between receipt of a recordable document and its availability to the searcher may be as much as two months.³⁴ Therefore, a subsequent secured party who gives new value and takes without notice is still not safe relying on the state of the PTO

²⁸ See discussion in PRELIMINARY REPORT #1, *supra* note 1 at Section III(c)(4).

²⁹ 35 U.S.C. § 261 (1994).

³⁰ See discussion in PRELIMINARY REPORT #1, *supra* note 1 at III(b)(3)(E).

³¹ *FilmTec Corp. v. Allied-Signal, Inc.*, 939 F.2d 1568, 1574, 19 U.S.P.Q.2d 1508, 1512-13 (Fed. Cir. 1991); *Katz v. Lear Siegler, Inc.*, 29 U.S.P.Q.2d 1450, 1453 (Fed. Cir. 1993) (unpublished).

³² Compare 35 U.S.C. § 261 (1994), with 17 U.S.C. § 205(d) (1994).

³³ See 37 C.F.R. § 3.51 (1994).

³⁴ See discussion in Preliminary Report #1, *supra* note 1 at Section III (a).

record until the three month look-back and the office delay period both pass.

The case in which a true assignment, grant or conveyance pre-dates a security interest is the best example of the Patent Act's displacement of the priority rules in Article Nine.³⁵ However, as the discussion in Section III(c)(3) et seq. explains, the case law to date opines that federal recording may also be critical when the security interest is executed *before* a competing assignment.³⁶

When the security interest is executed before a competing assignment, section 261 permits a much more generous time frame for recording than the otherwise applicable Article Nine rule in U.C.C. section 9-301(1)(d). Under section 9-301(1)(d), the secured party would lose to the subsequent purchaser of a general intangible if the purchaser "gives value without knowledge of the security interest and before it is perfected."³⁷ That same secured party prevails against a subsequent patent assignee who takes without knowledge as long as the secured transaction takes title-bearing form (e.g., conditional assignment) and is recorded in the PTO within three months of "its date."³⁸ Of course, a secured party does not know if it is prior or subsequent with respect to its own executed documents. The Patent Act poses an awkward recording and priority vehicle for lenders.

If the prior secured transaction takes the form of a security interest and is recorded with the PTO as a discretionary document,³⁹ it will provide inquiry notice to all who resort to the PTO file under the designated patent number or application number.⁴⁰ Therefore, in many cases, the filing of a security agreement will have the same priority effect as the filing of a conditional assignment. However, only the constructive notice assured by section 261 in the case of title-bearing "assignments" will bind those creditors and purchasers who do not resort to the record.⁴¹ A subsequent assignee of a patent or patent application who did not check the PTO file

³⁵ See discussion *supra* in PRELIMINARY REPORT #1, *supra* note 1 at Section III(c)(4).

³⁶ See 83 B.R. at 782; 48 B.R. at 639. But see *Holt v. United States*, 13 UCC 336, 339 (U.S. Dist. Ct., D.C. 1973); *Tollinger v. Ithaca Gun Company, Inc.*, 555 N.Y.Supp. 2d 908, 910-11 (App. Div. 3d Dept. 1990).

³⁷ U.C.C. § 9-301(1)(d).

³⁸ "Its date" is usually but not always the document execution date. 37 C.F.R. § 3.21.

³⁹ The mandatory cover sheet must refer to the specific patents by patent or application number. See 37 C.F.R. § 3.11 & § 3.31 (1997).

⁴⁰ Security interests are equitable interests that encumber the legal title to a patent. These interests survive a subsequent assignment if the assignee is on inquiry notice that the equitable interest exists. See *FilmTec Corp. v. Allied Signal, Inc.*, 939 F.2d 1568, 1573-74, 19 U.S.P.Q.2d 1508 (Fed. Cir. 1991).

⁴¹ See discussion in PRELIMINARY REPORT #1, *supra* note at Section III(c)(1)(C).

before the transfer would not be on inquiry notice and would not take subject to the security agreement. Although such a subsequent assignee would usually resort to the record, not all creditors do.

c) Secured Party vs. Secured Party

The logic of extending both the "assignment, grant and conveyance" language and the "purchaser or mortgagee" language to cover secured parties leads to the conclusion that section 261 also preempts the Article Nine rules on priority between secured parties.⁴² Instead of determining priority based on the first-to-file⁴³ a proper financing statement, the first secured party to take an assignment of an existing patent or patent application will prevail as long as that party records under section 261 within three months, or before a transfer to the subsequent secured party.⁴⁴ Remember, the prior secured party's interest cannot be recorded until a patent application is either executed or filed.⁴⁵

A subsequent secured party need not record at all, but can only prevail when the prior party remains unrecorded after the grace period and is unrecorded at the time the subsequent secured party's interest attaches. Even then, the subsequent secured party will not prevail unless it is bona fide and for "valuable consideration."⁴⁶

The bona fide or "without notice" qualification has an interesting wrinkle that could arguably restore some significance to Article Nine filing when the priority conflict is between secured parties. Under section 261, notice includes "constructive notice" and "inquiry notice" as well as "actual notice."⁴⁷ But, constructive notice cannot refer to 261 recording of an assignment because that would be redundant. A prior recorded

⁴² But see Weinberg & Woodward, *Easing Transfers, and Security Interest Transactions and Intellectual Property: An Agenda for Reform*, 79 KY. L. REV. 61, 67 n. 27 (1991).

⁴³ U.C.C. § 9-312(5)(a).

⁴⁴ 35 U.S.C. § 261 (1994). The date of the assignment is not always the document date. See discussion in PRELIMINARY REPORT #1, *supra* note 1 at footnote 529.

⁴⁵ The application number must normally be included. However, "[i]f an assignment is executed concurrently with, or subsequent to, the execution of the patent application, but before the patent application is filed, it must identify the patent application by its date of execution, name of each inventor, and title of the invention so that there can be no mistake as to the patent application intended". 37 C.F.R. § 3.21 (1997)(Emphasis added.).

⁴⁶ 35 U.S.C. § 261 (1994). See *FilmTec Corp. v. Allied Signal, Inc.*, 939 F.2d 1568, 1573-74, 19 U.S.P.Q.2d 1508 (Fed. Cir. 1991).

⁴⁷ *Id.*

assignee/secured party prevails over a subsequent taker by express proviso.⁴⁸ If "constructive notice" could include a preempted Article Nine filing a prior unrecorded secured party might take priority over a subsequent taker if the secured party had filed a financing statement. Although the patent cases on "notice" are very broad,⁴⁹ they probably cannot support such an extension. The logic of such a constructive notice holding would force all subsequent parties, not just secured parties, to check the appropriate state file as well as the PTO records - thus defeating the policy behind a partial preemption.

If a secured party is a section 261 protected "purchaser or mortgagee," the Article Nine concept of notice filing between secured parties would seem to be completely preempted under the *Otto Fabric and Transportation Design* interpretation of section 261, because a security interest would have to be formed as a present "conditional" assignment, and recorded.⁵⁰

In addition, after-acquired patent property would be a problem under section 261. Under Article Nine, priority between secured parties in after-acquired property goes to the first to file.⁵¹ If section 261 preempts Article Nine, priority goes to the first title-bearing assignment, if properly recorded within the grace period. A proper recording cannot occur, however, until the application is either executed or filed.⁵² Once the assignment of an application is properly recorded, the assignment will be applied against patents granted from the application including patents granted from divisional applications⁵³ and continuation applications.⁵⁴ Patents granted from continuation in part applications⁵⁵ and substitute applications⁵⁶ will not follow a recorded assignment of the original application, however, because the original only gives the assignee rights to subject matter common to both

⁴⁸ "...unless it is recorded...prior to the date of such subsequent purchase or mortgage." 35 U.S.C. § 261 (1994).

⁴⁹ See *FilmTec Core v. Allied Signal, Inc.*, 939 F.2d 1568 at 1573-74.

⁵⁰ See discussion in PRELIMINARY REPORT #1, *supra* note 1 at Section III(c)(3)(C) et seq.

⁵¹ See U.C.C. § 9-312(5)(a) & cmt. 4.

⁵² See 37 C.F.R. § 3.21 (1997).

⁵³ 35 U.S.C. § 121 (1994); 37 C.F.R. § 1.53, § 1.60 & § 1.62 (1997). See also Manual of Patent Examining Procedure [MPEP] § 201.06 (1998).

⁵⁴ See 37 C.F.R. § 1.53, § 1.60 & § 1.62 (1997); MPEP, *supra* note 53 at § 201.07. "In the case of a division or continuation, a prior assignment recorded against the original application is applied to the division or continuation application because the assignment recorded against the original application gives the assignee rights to the subject matter common to both applications." MPEP, *supra* note 53 at § 306.

⁵⁵ 37 C.F.R. § 1.53 & § 1.62 (1997). See also MPEP, *supra* note 53 at § 201.08.

⁵⁶ MPEP, *supra* note 53 at § 201.09.

applications.⁵⁷

A debtor with only equitable title in a patent or patent application may have sufficient "rights in collateral" for Article Nine attachment purposes,⁵⁸ but a present assignment of only equitable rights does not bring the secured party/assignee within the constructive notice scope of section 261.⁵⁹ Similarly, an assignment of a security interest is only a discretionary document unless it is accompanied by an assignment of all the debtor's right title and interest, subject to a condition subsequent of defeasance when the secured debt is paid.⁶⁰

Transportation Design is an example of a case where the debtor granted the secured party an interest in after-acquired patents. Under Article Nine, the secured party's prior filing of a financing statement naming the collateral by type provides priority against any later security interest even as to property not yet in existence.⁶¹ That priority would not be available under the preempting provisions of section 261 of the Patent Act. Instead, priority would attach to the first interest created and its progeny, but only if there is an existing application to record.⁶² This limitation on the capacity of section 261 to function as a notice filing statute puts an intolerable burden on the financing of ongoing research and development.

⁵⁷ MPEP, *supra* note 53 at § 306. Compare this extension with the more limiting concept of Article Nine "proceeds." See discussion in PRELIMINARY REPORT #1, *supra* note 1 at Section II(c)(2).

⁵⁸ See discussion in PRELIMINARY REPORT #1, *supra* note 1 at Section II(b)(3)(A).

⁵⁹ See discussion in PRELIMINARY REPORT #1, *supra* note 1 at Section III(c)(1)(C).

⁶⁰ See, e.g., Agreement Between Precision Engine Products Corp. and Bank of New York - Grant of Security Interests (Patents), PTO ASSIGNMENT BRANCH RECORDS Reel/Frame No. 7297/0185 (Recorded: Feb. 10, 1995).

⁶¹ See U.C.C. § 9-204(1); U.C.C. [Revised] § 9-204(a).

⁶² See 37 C.F.R. § 3.21 (1997).

APPENDIX 19 - WATERMAN. V. MACKENZIE

In *Waterman v. Mackenzie*, the inventor/licensee of a fountain pen holder ("Waterman") brought suit to enjoin an alleged infringement. The Supreme Court affirmed the lower Court's decision that the equitable action failed because title to the patent resided in a conditional assignee.¹ The diverting conditional assignment was intended as security for a note signed by Waterman and his wife. Prior to the conditional assignment, Waterman (the then owner of the patent) transferred the patent title to his wife, reserving back an exclusive license. The conditional assignment, executed by Mrs. Waterman to secure the note, was then made subject to patentee's license.² The Court affirmed the dismissal of Waterman's bill because a licensee without title cannot sue for infringement.³ The Court rejected Waterman's argument that the conditional collateral assignment did not pass title to the conditional assignee.

It is unlikely that the Supreme Court's conclusion in *Waterman v. Mackenzie* that the conditional assignee had "title," confirmed by a proper recording, really amounted to a holding that all unrecorded transfers for security are "void" as to subsequent parties under 261 because they must be conceived as "title" transfers as a matter of federal law.⁴ Instead of positing a federal title theory for security transfers, the case seems to conclude that the particular conditional assignment fell within the provisions of the Patent Act because *it was, in fact, cast* into a title mold under the then extant state law and state equity practice.⁵ In a particularly telling sentence, the Supreme Court concludes the conditional assignee "must be held entitled" to the incidents of title, "*unless otherwise provided in the mortgage.*"⁶ The clear

¹ Id at 261. After the decision in the Supreme Court the licensee/inventor joined the title holding the conditional assignee as a defendant and successfully asserted his right to sue for infringement. The second time was a charm because an infringement suit can be brought by a nontitle-holding licensee if the title holder is an infringer who cannot sue himself. *Waterman v. Shipman*, 55 F.2d 982 (2d Cir. 1893).

² Id. at 253.

³ Id. at 261.

⁴ The cases to date have not read *Waterman* to mean that the concept of a title-based chattel mortgage preempts the Article Nine concept of a security interest as a matter of federal law. See *In re Cybernetic Services, Inc.*, 239 B.R. 917, 920-21 (9th Cir. B.A.P. 1999); *Citibank & Trust Co. v. Otto Fabric, Inc.*, 83 B.R. 780, 782 (D. Kan. 1988); *In re Transportation, Design & Technology, Inc.*, 48 B.R. 635, 639 (Bankr. S.D. Cal. 1985).

⁵ 138 U.S. at 258-59. See also 239 B.R. at 920-21.

⁶ 138 U.S. at 260. See also *Curtiss v. U.S.* 13 U.S.P.Q. 400, 411 (Ct. Cl. 1932).

suggestion is that *this* transfer for security (the one before the Court in *Waterman*) presumes title under the existing state law, but another such transfer might effectively reserve most, if not all, of the rights of ownership in the transferor. Title passed to the conditional assignee in *Waterman v. Mackenzie* because of the extant state law conceptualizations about the need to transfer title in a chattel mortgage, not because of any necessary logic derived from the federal Patent Act. When *Waterman v. Mackenzie* was decided, the only security devise recognized for this type of personality was a form of the chattel mortgage. Legal title was the state law "concept" (some might say "fiction") used to define the right of the mortgagee to prevent waste of the asset. Unless this concept of legal title, as then recognized under state law, was somehow converted by the Supreme Court into an exclusive federal common law devise for protecting the mortgagee, the Article Nine security interest that carries no title should not be compelled to record under section 261 of the Patent Act. If a security interest is not "[a]n assignment grant or conveyance" within the meaning of section 261, the secured party properly attached and perfected by filing under state law would prevail over a subsequent assignee of the patent even if the security interest was never recorded in the Patent Office.⁷ While this more limited reading of *Waterman v. Mackenzie* has obvious analytical appeal, its application to modern Patent Act practice would no doubt weaken the integrity of the PTO assignment records. Probably for that reason, this restricted view of *Waterman v. Mackenzie* has minimal support in the case law.⁸

⁷ Holt v. U.S., 13 UCC 336, 338-39 (U.S. Dist. Ct. D.C. 1973). Priority would be based on U.C.C. § 9-201 & § 9-301(1)(d). Section 261 of the Patent Act would not trump the U.C.C. priority because the security interest would not be considered "an assignment, grant or conveyance" under the federal priority rule. See also *In re Cybernetic Services, Inc.*, 239 B.R. 917, 920-21 (9th Cir. B.A.P. 1999). *Cybernetic Services* finds that section 261 deals only with transfer of title transactions and that a security interest is not title dependent. 239 B.R. at 921. However, the Court also opines that an assignee of a patent would take free of a security interest that was not filed in the Patent Office. 239 B.R. at 920, n.8.

⁸ See cases cited *supra* at note 4.

APPENDIX 20 - RECENT PATENT ACT PREEMPTION CASES

A. *Transportation Design*

*In re Transportation Design & Technology, Inc.*¹ holds that an Article Nine local filing is effective to perfect a security interest in patent collateral against the bankruptcy trustee asserting lien creditor status under section 544(a)(1) of the Bankruptcy Code.² As part of this holding, the Court observed "the grant of a security interest is not a *conveyance* of a present ownership right in the patent and, . . . is not required to be recorded in the Patent Office."³ However, *dicta* in the opinion makes the case for a "partial" priority preemption. *Transportation Design* relies on *Waterman v. Mackenzie* for the following conclusion: ". . . a bona fide purchaser holding a duly recorded conveyance of the ownership rights in a patent or a mortgagee who has recorded its interest as a transfer of title with the Patent Office will defeat the interests of a secured creditor of the grantor or mortgagor who has not filed notice of its security interest in the Patent Office."⁴

Apparently, the Court, relying on *Waterman v. Mackenzie* finds the basis for a narrow preemption of both the *filing and priority rules* in Article Nine whenever the rights of an assignee or titled mortgagee, that has recorded, are in conflict with the ordinary security interest.⁵ Under section 261, if a prior assignee (or conditional assignee) fails to record within three months, it must record before the *execution* of a subsequent purchase or mortgage in order to prevail over such subsequent interest.⁶ The above quote from *Transportation Design* notwithstanding, as long as the subsequent purchase or mortgage is *bona fide* it need never record in order to assert priority over the prior unrecorded assignment. If the secured party is

¹ 48 B.R. 635 (Bankr. S.D. Cal. 1985).

² 11 U.S.C. § 544(a)(1) (1994).

³ 48 B.R. at 638.

⁴ 48 B.R. at 639.

⁵ As noted in Preliminary Report #1, there is a strong argument that neither section 261 nor *Waterman v. Mackenzie* support the "partial preemption" priority rule the Court proposes. See discussion in PRELIMINARY REPORT #1: AN OVERVIEW OF THE CURRENT LEGAL RULES AND STRUCTURES GOVERNING THE PERFECTION AND PRIORITY OF SECURITY INTERESTS IN INTELLECTUAL PROPERTY AND AN ANALYSIS OF PROPOSED LEGISLATIVE REFORMS at Section III (C)(3)(B) (Cooperative Contract - U.S.P.T.O. and Franklin Pierce Law Center 2000).

⁶ 35 U.S.C. § 261 (1994).

assumed to be prior in time under the dicta in *Transportation Design*, then it must record its interest in the Patent Office. However, unless the security interest is recorded as a title document, it will not fall within the constructive notice mandate of section 261.⁷ Therefore, the conclusion when *Waterman v. Mackenzie* is applied is that one must create a security interest by assignment to assure priority vis-a-vis a subsequent assignee. *Waterman v. Mackenzie* is not dead!⁸ The alternative of filing an ordinary security agreement (a possible construction of the *Transportation Design* dicta) with the PTO as a discretionary document may provide "inquiry notice" to those who access the file, but it will not be statutory constructive notice to all. Despite the confusing dicta in *Transportation Design*, the Patent Act seems to require a title document for constructive notice purposes and, while the bona fides of the subsequent party are relevant under section 261, recording by the subsequent party is not.⁹

Transportation Design fashions an approach to partial preemption that departs from the partial and full step-back concepts contained in Article Nine.¹⁰ Under the two-stage deferral approach suggested by Article Nine, the first question is whether recording in the Patent Office was a complete and exclusive substitute for Article Nine filing under section 9-302(3)(a)&(4). If

⁷ If the secured party took and recorded a security agreement instead of a title-bearing conditional assignment, it would not get the absolute record protection afforded a recorded conditional assignment. In the parlance of the Patent Act, a "security agreement" would convey a "lesser" equitable right to the secured party that would not qualify as an "assignment, grant or conveyance" subject to section 261. 239 B.R. at 920-21; 48 B.R. at 639. However, the "without notice" condition for bona fide purchaser status in 261 protects even equitable interests when the subsequent purchaser is chargeable with "inquiry notice" of the equitable right. *Hendrie v. Sayles*, 98 U.S. 546, 549 (1879); *FilmTec Corp. v. Allied-Signal, Inc.*, 939 F.2d 1568, 1573 (Fed. Cir. 1991). Those who searched the patent record after the discretionary recording of a security agreement should take subject to the security interest created thereby. Because some actual knowledge may be necessary to trigger inquiry notice, those foolish subsequent purchasers who buy without resort to the record, as well as subsequent involuntary takers such as lien creditors who never rely on the record, may not be subject to the prior "security agreement" recorded only with the PTO.

⁸ "[W]here a federal statute, such as the Patent Act, governs one area or interest which the secured creditor wishes to protect (e.g., ownership), then the federal statute pre-empts any other method of protecting that interest and is conclusive on the manner of protecting that interest. In other words, if the secured creditor wishes to protect itself against the debtor transferring title to the patent to a bona fide purchaser or mortgagee who properly records, then the secured creditor must bring its security interest (which is not ordinarily a transfer of title) within the provisions of the Patent Act governing transfer of title to patents." 48 B.R. at 639-40.

⁹ *Id.*

¹⁰ See discussion in PRELIMINARY REPORT #1, *supra* note 5 at Section II(f).

the Patent Act "provides for a national registration" within the meaning of section 9-302(3)(a), then Article Nine filing is neither "necessary *or effective*."¹¹ "Compliance" with the federal statute then becomes the exclusive method of "perfection" under section 9-302(4).¹² Section 9-302 makes no provision for the *partial displacement* of the Article Nine filing provisions. If the filing rules are displaced as a mode of perfection by operation of section 9-302, they are displaced in *all* cases where perfection is important to priority.¹³ However, because *Transportation Design* ignored the section 9-302(3)(a) approach, the preliminary issue of "national registration" for security interests under the Patent Act is never *directly* addressed. Instead, the Court decides half of the section 9-302(3)(a) issue *indirectly* by concluding that state "perfection" works at least against the lien creditor under U.C.C. section 9-301(1)(b).

While preemption, even partial preemption, is federal law and operates apart from Article Nine notions, the jerry-built "partial filing and priority preemption" theory in the *Transportation Design* dicta is troublesome. It may not be a reliable guide to the scope and function of the priority rule in section 261 of the Patent Act.¹⁴

B. Chesapeake Fiber

Even though the dicta in *Transportation Design* is flawed, it has had some influence. Relying on *Transportation Design*, the U.S. District Court for the District of Maryland in *Chesapeake Fiber Packaging Corp. v. Sebro Packing Corp.*¹⁵ applied section 261 to resolve a challenge by the original assignor of a patent application to the security interest held by the bankrupt assignee's secured party. The assignor argued that the secured party was unperfected without a PTO recording and thus subordinate to the assignor whose subsequent "reacquisition" made it a protected section 261 purchaser.¹⁶ The Court in *Chesapeake Fiber* found for the secured party only because the original patent assignor could not qualify as a subsequent section 261 "purchaser," not because section 261 did not apply.¹⁷

¹¹ U.C.C. § 9-302(3)(1st sentence) (Emphasis added.).

¹² U.C.C. § 9-302(4).

¹³ *Id.*

¹⁴ See discussion in PRELIMINARY REPORT #1, *supra* note 5 at text accompanying footnote 591 to 600.

¹⁵ 143 B.R. 360, (D. Md. 1992), *aff'd*, 8 F.3d 817 (4th Cir. 1993).

¹⁶ 143 B.R. at 368.

¹⁷ 143 B.R. at 369. Arguably, the assignor could have protected its rights in the assigned patent with a security interest that might have qualified for purchase-money priority. See

C. *Otto Fabric*

Three years after *Transportation Design*, the United States District Court for the District of Kansas held that a security interest in a patent was "perfected" against an imaginary lien creditor from the time it was properly filed under Article Nine, rather than from the time it was recorded with the Patent Office. The holding in *City Bank and Trust Co. v. Otto Fabric, Inc.*¹⁸ is also accompanied by dicta that sends a mixed message about the scope of federal preemption.

Unlike *Transportation Design*, the moment of "perfection" was important in *Otto Fabric* because it was triggered/controlled by the Bankruptcy Code. Under section 547(e)(2) of the Bankruptcy Code, "perfection" marked the "deemed" date of the security transfer for purposes of the 90-day period for avoiding preferences.¹⁹ Except for the issue of *when* it was "deemed" to have occurred, the transfer for security in *Otto Fabric* satisfied all the other requirements for a preference that was avoidable by the bankruptcy trustee under section 547(b) of the Bankruptcy Code.²⁰ If the transfer date was marked by the local U.C.C. filing, it would *not* be avoidable because it would fall *outside* the 90-day pre-petition "preference period" in section 547(b)(4)(A).²¹ If perfection was marked by the later federal PTO recording, however, the security transfer would be avoidable because it would fall *within* the 90-day preference period.

The *Otto Fabrics* Court held that state law and the secured party's Article Nine filing applies conclusively, *but not exclusively*, to resolve the question of "perfection" in favor of the secured party. Alternatively, the Court held that if the Patent Act did preempt "the field of filing," section 261 offers no protection for lien creditors or trustees invested with lien creditor status.²²

As in *Transportation Design*, the *Otto Fabrics* Court ignored the Article Nine structure that conceives of a partial deferral as a "filing" deferral under U.C.C. section 9-302(3)(a) and (4). While federal preemption need not follow the guidelines suggested in the preempted state statute, the

the prior discussion of this aspect of the *Sebro* case *supra* at note 476. See, e.g., *Haraway v. Burnett*, 1997 Tenn. App. LEXIS 611 at *2-3, 33 UCC2d 1256 (1997)(Assignor of patents retains security interest in them to secure assignee's obligation to make sales contract and royalty payments).

¹⁸ 83 B.R. 780, 7 U.S.P.Q.2d 1719, 5 UCC2d 1459 (D. Kan. 1988).

¹⁹ 11 U.S.C. § 547(e)(2)(B)& (e)(1)(B).

²⁰ 83 B.R. at 782.

²¹ 11 U.S.C. § 547(b)(4)(A) (1994).

²² 83 B.R. at 782.

Otto Fabrics approach seems tied to three inconsistent conclusions.

The first flawed conclusion in *Otto Fabric* is that a PTO recording would be equally as effective as an Article Nine filing to defeat the hypothetical lien creditor under state law.²³ The second flawed conclusion is that if section 261 of the Patent Act "completely preempted the field of filing" its substantive provisions would leave the lien creditor, who could have priority under Article Nine, with no federal law basis for priority against the secured party.²⁴ Finally, testing the complete opposite thesis, the Court observed that a security interest is not a conveyance of title or ownership rights under the recording mandate of section 261.²⁵

As to the Court's first observation on the applicable state law, the filing deferral rules in U.C.C. section 9-302(3)(a) and (4) *do not* comprehend double recording. If the Patent Act recording displaces under section 9-302(3)(a), it displaces completely under section 9-302(4). On the other hand, if the Patent Act did not create a national registry, which supplants Article Nine for "perfection" purposes, filing with the PTO would not protect against the lien creditor, at least under state law.²⁶ On the federal side, no reasonable take on the language of section 261 would allow the secured party to "perfect" its interest against the involuntary lien creditor by recording in the Patent Office.²⁷ Involuntary transfers are not even mentioned in the text of section 261. If a section 261 recording did provide priority against the involuntary lien creditor under federal law, state law covering the same ground would surely be preempted and a U.C.C. filing would not even be an alternative way to gain priority over the lien creditor.

This observation about the narrow field of play in section 261 leads to the Court's second flawed conclusion. If federal law did in fact control, the Court concluded that it would leave the lien creditor without any statutory priority. Any hypothesis based on complete preemption by section 261 seems an unlikely alternative holding. Assuming the Court's reference to complete preemption of the "field of filing" really envisions complete preemption of Article Nine, then it may be true that section 261, does not require recording to defeat the lien creditor. But as *Peregrine* felt compelled

²³ After upholding U.C.C. based perfection against the lien creditor, the court volunteers the statement that "*recording an assignment* [in the PTO] would also protect the assignee against the claims of a subsequent lien creditor." 83 B.R. at 782.

²⁴ 83 B.R. at 782.

²⁵ 83 B.R. at 782-3.

²⁶ "Perfection" here means the time when the transfer beats the lien creditor under section 547(e) of the Bankruptcy Code. 11 U.S.C. § 547(e)(1)(B) (1994). See U.C.C. § 9-301(1)(b); U.C.C. [Revised] § 9-317(a)(2).

²⁷ 35 U.S.C. § 261 (1994).

to conclude,²⁸ complete federal preemption of Article Nine can hardly be mandated unless the displacing federal recording scheme acknowledge/recognizes lien creditors.²⁹

At the other extreme, the title-related dicta in *Otto Fabric* deals even the partial preemption theory a final blow. Emphasizing the theory's "partial" nature, the Court noted that a security interest is not like a collateral assignment. Relying on *Holt v. U.S.*,³⁰ the Court used the following language to conceptualize the creditor's security interest:

"To require a federal filing and thus a collateral assignment to perfect a security interest in a patent seems inconsistent with the modern notion that a grant of a security interest need not include the conveyance of title or ownership rights."³¹

Of course, the problem with this statement is that it goes too far in describing the "partial" nature of the preemption. Once the security interest is placed outside the "assignment grant or conveyance" language in section 261, the secured party's priority even as against subsequent purchasers and mortgagees would be controlled by Article Nine, not by the federal Patent Act.

As was the case with *Transportation Design*, *Otto Fabric* seemed to base its holding on a patchwork notion of "partial preemption." Once again, the Court's attempt at guidance in the dicta is very confusing.

D. Cybernetic Services

In re Cybernetic Services, Inc.,³² a recent decision from the Ninth Circuit Bankruptcy Appellate Panel, follows the lead of both *Transportation Design* and *Otto Fabric* in concluding that Article Nine perfection is sufficient against the lien creditor. Here again, however, the Court's dicta touched on priority between the assignee and the secured party and paints an uncertain picture of this priority contest. Although the Court observed that a security interest is not the kind of title-bearing transfer envisioned by the "assignment, grant or conveyance" language in section 261, it also agreed with *Transportation Design* that an assignee would defeat a secured creditor

²⁸ 116 B.R. at 205.

²⁹ Revised Article Nine purports to limit any federal statute that would displace the U.C.C. filing provisions to a statute "whose requirements for a security interest's obtaining priority over the rights of a lien creditor with respect to the property preempt...." U.C.C. [Revised] § 9-311(a)(1).

³⁰ *Holt v. U.S.*, 13 UCC 336, 338-39 (U.S. Dist. Ct. D.C. 1973).

³¹ 5 UCC2d at 1463.

³² 239 B.R. 917 (9th Cir. B.A.P. 1999).

"who has not filed notice of its security interest in the Patent Office."³³

E. Summary of Preemption Cases

If we focus on the narrow holdings of the four cases discussed above, *Cybernetic Services*, *Otto Fabric* and *Transportation Design* all arguably stand for the proposition that the Patent Act *does not* render an Article Nine filing for "perfection" ineffective against the lien creditor. For purposes of Bankruptcy Code avoidance and preference law, this is the critical issue. In that contest, local Article Nine filing controls on both the perfection and the priority issue. Although *Otto Fabric* is not as clear as either *Transportation Design* or *Cybernetic Services* on what *may be* preempted by section 261, all three cases indicate that the secured party must record a security transfer, in title form, under section 261 of the Patent Act in order to defeat a subsequent purchaser or mortgagee.³⁴ Despite this overrated reliance on *Waterman v. Mackenzie*,³⁵ this limited Patent Office recording requirement will likely prevail as a matter of transactional policy. Courts are and should be concerned about the integrity of the Patent Office files. The PTO file is relied on by potential buyers or assignees who need to know the state of a patent title. If a security interest must, in the context of subsequent title takers, be formed into some title-bearing assignment, then potential buyers and assignees are relieved of the burden of searching undetermined state U.C.C. files before safely acquiring an ownership interest in a patent. Given the level of uncertainty, a cautious lender must do it both ways, at least for now. Prudence suggests that the secured party file a "financing statement" under state law and also requires that the debtor execute a "title" document that can be recorded in the Patent Office as either a patent mortgage or a conditional assignment.

³³ 239 B.R. at 920-21 & n.8.

³⁴ 239 B.R. at 920, n.8; 83 B.R. at 782; 48 B.R. at 639.

³⁵ See discussion in PRELIMINARY REPORT #1, *supra* note 5 at Section III(c)(3)(B).

APPENDIX 21 – ANALYSIS OF UCC FILING PROCEDURES FOR SELECTED STATES

A. New Hampshire - Current System

1. Current System (New Hampshire)

Paper form UCC1 is completed and sent to the New Hampshire Secretary of State's office along with associated fees. This form contains debtor and creditor names and addresses as well as the type of filing. Collateral is also listed on this form. The state records the date and time of receipt, assigns a unique identifying number and stores the physical forms in a filing cabinet system.

Form UCC3 is used for amending, assigning, continuing and partial releases of UCC filings.

To request a search, form UCC11A is completed and sent to the Secretary of State's office. A manual search of the files is performed by employees of the Secretary of State's office and results of the search are mailed or faxed to the requestor.

2. New Hampshire – New System

A new information management system is currently being developed jointly between the state of NH and a contractor. "Acceptance Criteria and Specifications" describes in detail the scope and structure of said system. According to Assistant Secretary of State, Anthony Stevens, the software is at the alpha testing stage. It is expected to be in beta usage mode by the end of May 2000 and in use by the summer of 2000.

In summary, the new information management system requires that the standardized National Financing Statement Form UCC1 be completed and sent in paper form to the New Hampshire Secretary of State's office along with associated fees. The state then enters the information into an electronic information system/database per the method described in "Amendment-UCC Image Enablement."

Form UCC3 will continue to be used for amending, assigning, continuing and partial releases, however, this information will be entered into the information system per the procedure described in the Image Enablement amendment as well.

Form UCC11A will still need to be completed to request a search. The state will search the database and send the results to the requestor. According to Mr. Stevens, outside access to the database is not anticipated.

B. Data Structure of New Information Management System

1. **Identification Numbers.** Each initial financing statement is identified by its file number. A record is created in the System for each initial financing statement and all information comprising such record is maintained in such system. Such record is identified by the same information assigned to the initial financing statement. A UCC document other than an initial financing statement is identified by a unique file number assigned by the filing officer. In the System, records of all UCC documents other than initial financing statements are linked to the record of their related initial financing statement.
2. **Type of document.** The type of UCC document from which data is transferred is identified in the System from information supplied by the remitter.
3. **Filing date and filing time.** The filing date and filing time of UCC documents are stored in the System. Calculation of the lapse date of an initial financing statement is based upon the filing date.
4. **Identification of parties.** The names and addresses of debtors and secured parties are transferred from UCC documents to the System using one or more data entry or transmittal techniques. In the System, each party has a status of *active* or *inactive* and a designation as an individual or organization.
5. **Status of financing statement.** In the System, each financing statement has a status of *active* or *inactive*.
6. **Page count.** The total number of pages in a UCC document as maintained in the System.
7. **Presentation Media Indicator.** The source from which the document record was created in the System (e.g., paper, EDI, a global change). This should be a one-byte field, and representative values shall be as follows: If a filing record is created from the global filing program, place a "G" in the field. If a filing record is created from paper, place a "P" in the field. If a filing record is created from an EDI

transmission place an "E" in this field. This field will be used in later development of the UCC information system.

8. **Lapsed Indicator.** An indicator by which the UCC Management System identifies whether a filing has lapsed. It is not absolutely necessary to have a lapse indicator as long as the requested search results can be obtained in a timely manner.
9. **Comment Field.** Each initial filing record shall have the ability to have multiple comment fields. The comment fields shall be 50 bytes in length. The comment field or fields shall be used by the State to record administrative remarks as they relate to the lien. These fields shall be accessible from the system maintenance options only.
10. **NH Special Field.** A special field may be used by amendments that were filed without being assigned their own filing numbers. There are some UCC liens that have not been assigned a unique filing number for each associated UCC 3. These UCC 3's currently have the same number as the UCC 1. It has been anticipated that this field could be used in some manner to solve this problem when doing data conversion. Another possible solution could be to add a -1, -2, etc. behind each sequential UCC 3 that have the same number as the associated UCC 1. This would have to be coordinated with the final design of the numbering system and integrated with the use of check digits, if used, and the current or future maximum length of the file number field.
11. **Lapsed Date.** A date is maintained by which the System identifies when and if a financing statement will lapse.
12. **Transaction Number Field.** The accounting transaction number related to the receipt of payment associated with the filing.

C. Florida

The State of Florida allows for the filing of UCC's using paper form UCC1 and amending using paper form UCC3. Completed forms are sent to the Department of State, Division of Corporations for their input into the computer system by department personnel.

Additionally, the state allows for electronic filing, amending and searching via the Internet at no cost. To those with an active account, Electronic filing and amending forms can be accessed at <https://ccfss1.dos.state.fl.us/corpweb/efiling/onlmenu.html>. The UCC database can be searched by anyone with a web browser at site <http://ccfcorp.dos.state.fl.us/corpweb/inquiry/lienmenu.html>.

D. California

Completed filing form UCC1 must be brought to an office of the Secretary of State. If the form cannot be brought in by the filer, a service company must be retained to do so. Information from these forms is entered into California's electronic database system.

California uses Form UCC2 for amending, assigning, continuing and partial releases of UCC filings. Again, such filings must be done in person. If the filer is unavailable, a service provider must be hired. A request for information is made by submitting form UCC3. State employees perform the search as requested and report the results to the requestor via mail or fax.

E. Arizona

Arizona's system for filing, amending and searching UCC's is very similar to that of California's. Forms UCC1 for initial filing and UCC2 for amending are sent to the state office where state workers enter the information into their electronic database.

For searching, form UCC3 is sent to the state for them to perform a search of their database. The results are returned to the requestor.

APPENDIX 22 – RECORDING (STATE) SYSTEM FOR TRADEMARKS (NEW HAMPSHIRE AND OTHER SELECTED STATES)

A. *New Hampshire*

An application form needs to be completed and sent to the Secretary of State's office along with the \$50.00 filing fee. Application instructions for registering trade/service marks in New Hampshire are as follows:

APPLICANT may be an individual, partnership, or corporation. Use full name. If a New Hampshire corporation, it must appear in the N.H. Secretary of State's files.

DESCRIPTION OF MARK: Describe mark fully, both wording and design or pictorial features such as logo. It must be clear from this description and the specimens exactly what is to be registered, or the application will be rejected.

DESCRIPTION OF GOODS OR SERVICES should describe what the mark is being applied to.

CLASS: Enter one class only on each registration; see list below.

MARK APPLIED TO should describe how the mark is to be used, i.e. on labels attached to goods, displays such as advertising, etc.

DATES OF FIRST USE: These are the dates the mark was first used 1) anywhere and 2) in New Hampshire. The dates may be the same, but cannot be in the future.

SIGNATURES (by an officer if a corporation or partner if a partnership) MUST BE NOTARIZED.

ENCLOSE \$50 AND THREE IDENTICAL SPECIMENS OR FACSIMILES ON PAPER.

NOTE: A mark may not be registered if it consists of or comprises the flag, coat of arms, etc. of the United States, any state or foreign country, or the name, signature, or portrait of any living individual, except with written consent. A mark that is merely descriptive of goods or services may not be registered unless it has become distinctive of the applicant's goods or services. The Secretary of State may require proof of continuous use for five years as evidence that the mark has become distinctive. See RSA 350-A:2 for further restrictions.

B. California

From web site www.ss.ca.gov/business/ts/ts.htm, "The Secretary of State's Office maintains registration and all updates of trademarks and service marks used in California, making this information accessible to the public upon request."

Pages one and two of the online document, www.ss.ca.gov/business/ts/forms/tm-100.pdf describe the registration requirements of filing trade and service marks in the State of California. Pages three through six of the document are the actual forms for filing.

C. Massachusetts

Procedures describing the filing of trademarks in Massachusetts are found on site <http://www.magnet.state.ma.us/sec/cor/cortmsm/tmsminf.htm>.

The trademark or service mark application (submitted in duplicate) shall contain the following information:

1. the name of the applicant;
2. the business address of the applicant;
3. whether the applicant is an individual partnership, corporation, union or association;
4. if a corporation, the state of incorporation;
5. a description of the mark;
6. a description of the goods or services in connection with which the mark is used;
7. the class number of the goods or services (see the classifications of goods and services supplied below) (this may be left blank on the application);
8. a statement of how the mark is used;

9. the date of first use of the mark by applicant or predecessor in Massachusetts and anywhere;
10. identify any predecessor and describe use by predecessor; and
11. a statement that the applicant is the owner of the mark and that no other person has the right to use the mark in the Commonwealth either in identical form or in any form so similar as thereto as to deceive or be mistaken for.

The application must be signed by the applicant or by a member of the firm or an officer of the corporation, or association. Applicant's signature must be notarized. Staple or clip three specimens of the mark to the application. Do not glue or tape them. Specimens larger than 3"x3" will not be accepted.

The fee for filing a mark is fifty dollars (\$50.00) payable by cash, check or money order to the Commonwealth of Massachusetts.

The term of registration is ten (10) years. The owner will be notified to renew his registration within six months prior to the expiration of the term.

(<http://www.magnet.state.ma.us/sec/cor/cortmsm/tmsmfrm.htm>).

APPENDIX 23 – RECORDING (FEDERAL) SYSTEM FOR TRADEMARKS

“A TRADEMARK is either a word, phrase, symbol or design, or combination of words, phrases, symbols or designs, which identifies and distinguishes the source of the goods or services of one party from those of others.” (*Basic Facts About Registering a Trademark*, USPTO)

The filing process is manual or electronic (see below). In the manual process, PTO form 1478 has to be filed for each application along with the filing fee (\$325 per filing) and a drawing of the mark.

The Patent and Trademark Office has developed a new Trademark Electronic Business Center (“TEBC”) as part of their E-Commerce initiative. TEBC offers three services:

1. Trademark Electronic Application System (“TEAS”). Two alternatives for filing are provided. The first approach, **e-TEAS**, is an electronic, online filing system where applicants can attach an electronic image of design marks along with online credit card payment. The second approach, **PrinTEAS**, involves completing the application online, printing, and mailing the form along with the filing fee and a copy of design mark.
2. Trademark Electronic Search System (“TESS”). TESS provides a web-based interactive search capability.
3. Trademark Application registration retrieval (“TARR”). TARR is a web-based interactive system, which provides information about pending and registered trademarks obtained from the USPTO’s internal database.

Online Information Resources

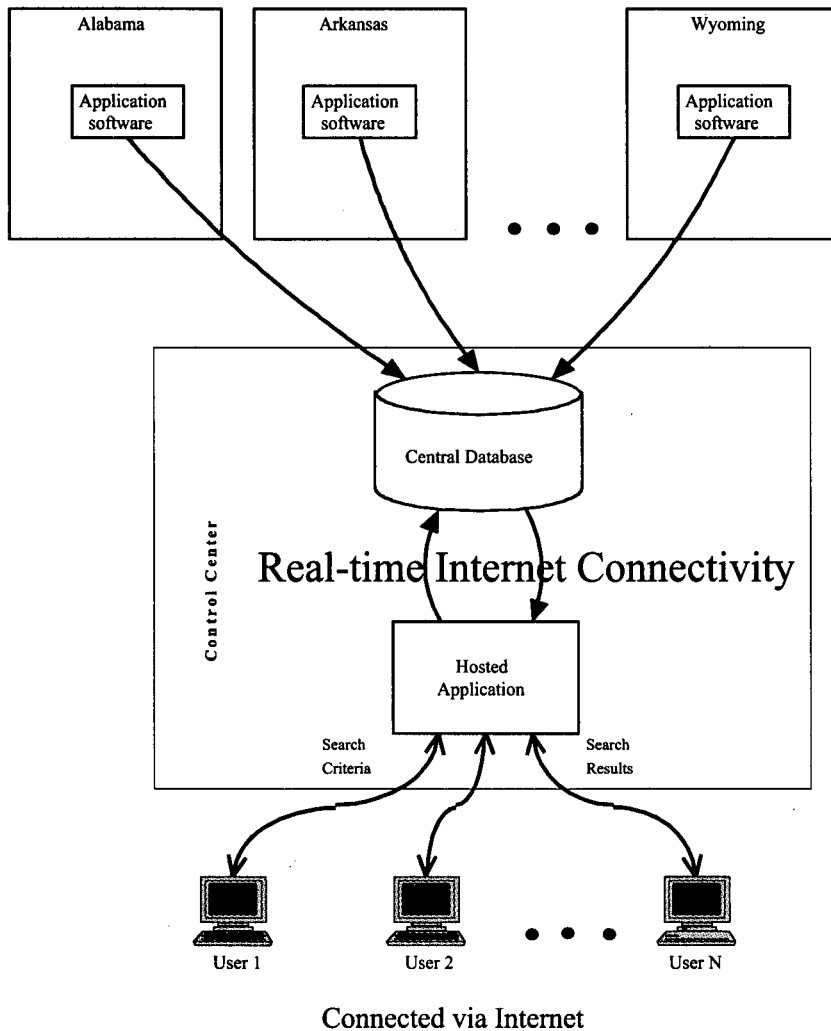
www.uspto.gov

<http://www.uspto.gov/web/menu/tm.html>

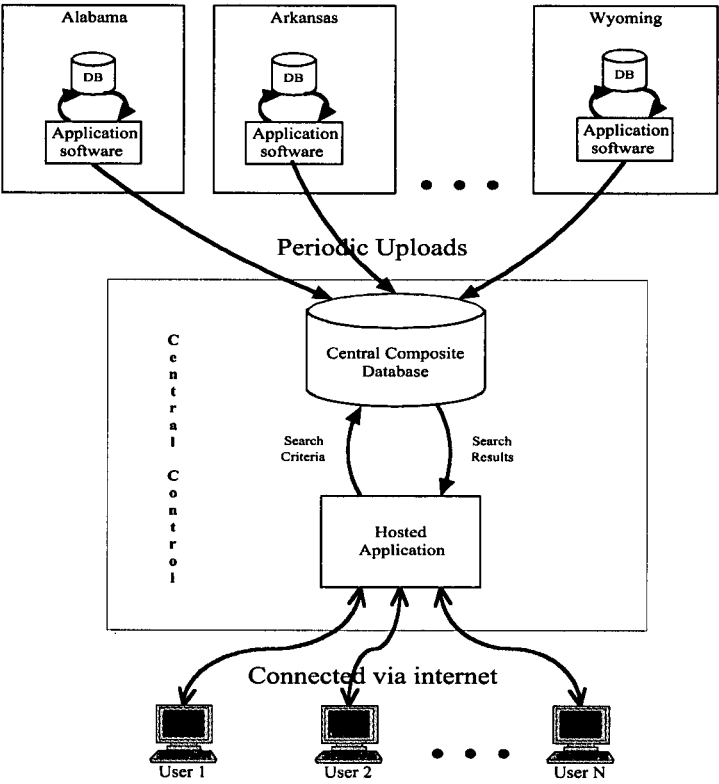
<http://www.uspto.gov/web/menu/tmefc/index.html>

APPENDIX 24 - PROPOSED TECHNOLOGICAL SYSTEM SOLUTIONS

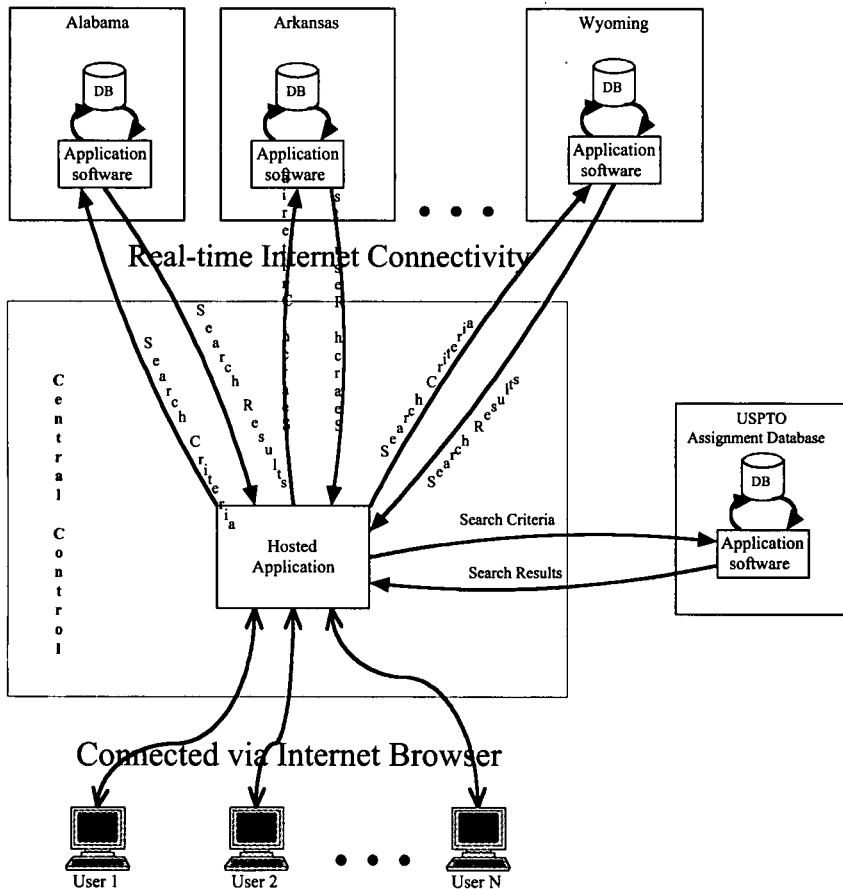
Ideal Technological Solution



Next-best Solution



Proposed Solution



APPENDIX 25 – PENDING FEDERAL REFORMS

A comprehensive discussion of pending federal reform proposals as of February 1, 2000 is contained in PRELIMINARY REPORT # 1: AN OVERVIEW OF THE CURRENT LEGAL STRUCTURES GOVERNING THE PERFECTION AND PRIORITY OF SECURITY INTERESTS IN INTELLECTUAL PROPERTY AND AN ANALYSIS OF PROPOSED REFORMS at section IV, pages 166-188.

APPENDIX 26 - THE EFFECT OF BANKRUPTCY UPON A FIRM USING PATENTS AND TRADEMARKS AS COLLATERAL

by Lois R. Lupica*

© Lois R. Lupica 2001

INTRODUCTION

The Bankruptcy Code sets forth an orderly process for the distribution of a debtor-in- bankruptcy's assets. This process has the effect of altering many of the procedural and substantive rights and obligations of the debtor, as well as of the debtor's creditors. Parties asserting a property interest in assets of a debtor in bankruptcy, however, must rely on non-bankruptcy law to determine the nature and extent of their property interests. The most commonly asserted interest by creditors involved in a bankruptcy are security interests.

Security interests are consensual liens that arise at the inception of a credit transaction. While security interests are enforceable between parties to the credit transaction and as against third parties at the moment of their creation, secured parties must "perfect" their interests for their interests to

* Associate Professor of Law, University of Maine School of Law. B.S. 1981, Cornell University; J.D. 1987, Boston University School of Law.

survive a bankruptcy filing. The importance of the concept of perfection of security interests in bankruptcy cannot be overstated. An unperfected security interest can be avoided by the debtor's trustee in bankruptcy for the benefit of the bankruptcy estate. "Perfection for purposes of the Bankruptcy Code means priority against the ordinary creditor with a judicial lien (the lien creditor).

The body of non-bankruptcy law most often implicated when personal property is used as collateral is the state law captured in Article 9 of the Uniform Commercial Code (U.C.C.). Article 9 went through a major revision in 1998. Both the "old" and "revised" versions of the Article outline the rules for perfecting security interests in personal property collateral, and define the priority rights held by secured parties. Primary among the priority rights defined in Article 9 is the rule that a security interest that is perfected by a proper state notice filing has priority over the creditor with a competing lien (the lien creditor). The priority rule for lien creditors is just one of many rules in Article 9 designed to provide clear and certain rights to all parties in competition with security interests in all forms of personal property. Intangible personal property falls within the broad jurisdictional scope of Article 9.

The scope of Article 9, however, is not absolute. To the extent that Article 9 is preempted by another body of federal law, the preempting law governs the issue of how to establish a "perfected" security interest. Both the Patent Act and the Lanham Act include recording and transfer provisions. Both of these provisions protect subsequent purchasers against unrecorded assignments. It does not appear from the face of either statute, however, that the ordinary lien creditor qualifies as a protected purchaser.

The preemptive force of these statutes remains uncertain, however, because some courts have defined the concept of protected transferee very broadly when dealing with federal recording provisions.

This uncertainty takes on greater urgency when the debtor, as owner of the intellectual property, files for bankruptcy protection.¹ Bankruptcy provides an acid test for the efficacy of non-bankruptcy law perfection of security interests; unperfected security interests are subject to avoidance in bankruptcy. The following sections outline the central effects of bankruptcy upon a firm using patents and trademarks as collateral.

¹ See <http://www.thestandard.com/article/display/listing>, in what is called the "Dot-com Flop Tracker" internet companies that have failed).

PERFECTION OF SECURITY INTERESTS IN PATENTS AND TRADEMARKS**A. Perfection Put to the Section 544(a) Avoiding Powers Test**

Non-bankruptcy legal regimes outline the methods for the transfer of interests in patents and trademarks – namely the Patent Act² and the Lanham Act.³ Both of these federal statutes provides a method of documenting and recording interests in intellectual property by the specific property number assigned by the appropriate federal regulatory agency. A structural element common to these statutes is their linkage of the concepts of transfer and title.

Financiers seeking to take a security interest in most types of personal property look to Article 9, which dissociates the concept of title and security interest transfers and provides an efficient and streamlined method of attachment and perfection of security interests. Article 9 states, subject to certain specified exceptions, that it governs “any transaction (regardless of its form) which is intended to create a security interest in personal property or fixtures including goods, documents, instruments, general intangibles, chattel paper or accounts. . . .”⁴ As comprehensive in scope as Article 9 is, it also recognizes its potential for displacement, in deference to the federal intellectual property regimes.⁵ Both the Patent Act and the Lanham Act address the issue of transfer of an interest in intellectual property, but do not specifically mention, in the language of Article 9, the issues of creation, attachment, perfection and priority of security interests. Moreover, Article 9 simply provides that *if* another body of law governs these matters, *then* Article 9 steps-back or is preempted. Section 9-104(a) of old Article 9, known as the “step-back” provision reads:

This Article does not apply to a security interest subject to

² Section 261 of the Patent Act states, “An assignment, grant or conveyance shall be void as against any subsequent purchaser or mortgagee for valuable consideration, without notice, unless it is recorded in the Patent and Trademark Office within three months from its date or prior to the date of subsequent purchase or mortgage.” 35 U.S.C. § 261 (1994).

³ Section 1060 of the Lanham Act reads in part: An assignment shall be void as against any subsequent purchaser for a valuable consideration without notice, unless it is recorded in the Patent and Trademark Office within three months after the date thereof or prior to such subsequent purchase. 15 U.S.C. § 1060 (1994).

⁴ U.C.C. § 9-102 (1996).

⁵ U.C.C. § 9-104(a) (1996).

any statute of the United States to the extent that such statute governs the rights of parties to and third parties affected by transactions in particular types of property.⁶

Moreover, old section 9-302(3)(a) states that an Article 9 filing “is not necessary or effective to perfect a security interest in property subject to “a statute . . . of the United States which provides for a national or international registration . . . or which specifies a place of filing different from that specified in this Article.” The Official Comment to section 9-302(3)(a) states:

Subsection (3) exempts from the filing provisions of this Article transactions as to which an adequate system of filing, state or federal, has been set up outside this Article and subsection (4) makes clear that when such a system exists perfection of a relevant security interest can be had only through compliance with that system (i.e., filing under this Article is not a permissible alternative).⁸

Revised Article 9 also provides for the preemption of its provisions by federal statute in sections 9-109(c)(1) and 9-311(a)(1).⁹ It should be noted that the new filing preemption language in section 9-311(a)(1) does not direct perfection or filing questions towards a statute of the United States unless that statute contains a priority rule for lien creditors.

It is not apparent, however, from the text of either “old” or “revised” Article 9 nor from the law addressing the title and transfer of interests in patents and trademarks, exactly which legal regime governs the attachment, perfection and determination of priority of security interests in patents and trademarks. This is of concern because the issue of perfection of security interests in patents and trademarks is at the heart of many of the fundamental issues that arise in a debtor-with-intellectual-property’s bankruptcy.

When a debtor files for bankruptcy, its trustee becomes interested in determining whether any non-bankruptcy claimed rights (such as

⁶ Id.

⁷ U.C.C. § 9-302(3)(a) (1996).

⁸ U.C.C. § 9-302(3)(a) (1996) cmt.

⁹ U.C.C. [Revised] § 9-311(a)(1).

perfected security interests) are vulnerable to defeat.¹⁰ The trustee has the power, under § 544(a) of the bankruptcy code, to upset the interests of an unperfected creditor, thereby limiting the creditor's ability to receive the full measure of what they are owed in the debtor's bankruptcy.¹¹ As the cases discussed below illustrate, perfection of security interests for § 544(a) purposes is the most common context for the questions about perfection. The issue of perfection of security interests also arises in the context of the trustee's avoidance powers pursuant to section 547 (preferences) and section 548 (fraudulent conveyances). Preferences and fraudulent conveyances in the context of transfers of interests of patents and trademarks will be discussed in Part III.

(i) Perfection of Security Interests in Patents

The Patent Act states that the "assignment, grant or conveyance" of an interest in a patent "shall be void against any subsequent purchaser or mortgagee" unless the assignment, grant or conveyance is recorded in the PTO within three months from its date, or prior to the date of such purchase or mortgage.¹² While this provision is designed to address the issue of the steps necessary to be taken to effectuate a transfer of interest in a patent, it is not clear the extent to which this provision preempts Article 9 when the transferred interest at issue is security interest.

The court in *In re Transportation Design and Technology, Inc.*,¹³ addressed the question of whether the section 261 of the Patent Act preempts Article 9 with respect to transfers of security interests in patents. The court stated that the language in the Patent Act providing for the recordation of an assignment speaks to the issue of a transfer of title and

¹⁰ The trustee . . . may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by -

(1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property in which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists; 11 U.S.C. § 544(a)(1)(1997).

¹¹ Under Section 541(a)(3), interests recovered under § 550 become property of the estate. Section 541(a)(3) reads: (a) . . . [The] estate is comprised of all of the following property, wherever located and by whomever held: (3) Any interest in property that the trustee recovers under section . . . 550. . . of this title. 11 U.S.C. § 541(a)(3) (1997).

¹² 35 U.S.C. § 261 (1994).

¹³ *In re Transportation Design and Technology, Inc.*, 48 B.R. 635 (Bankr. S.D. Cal. 1985).

does not include within its meaning the transfer of a security interest. The *Transportation Design* court concluded that only an Article Nine filing protects the secured party with an interest in a recorded patent against the bankruptcy trustee. The court did note in dicta, however, that recording under section 261 of the Patent Act is necessary to protect the secured party against subsequent assignees of the patent, including a secured party that characterized its security interest as a “conditional assignment.”

Following the lead of *Transportation Design*, the Bankruptcy Appellate Panel in *In re Cybernetics Services, Inc.*, held that only an Article 9 filing was sufficient to perfect a security interest in a patent. In this case, the debtor owned a patent for a video signal collection device. Creditor had a security interest in all of debtor’s assets, including “general intangibles” and filed a financing statement to perfect its security interest in the Article 9 filing office. No financing statement filed or recordation of a transfer of interest was made in the Patent office. Upon debtor’s bankruptcy, creditor moved for relief from the automatic stay in order to enforce its security interest in the patent. The trustee opposed this motion and argued that the creditor’s security interest in the patents was unperfected and therefore avoidable because the transfer of interest was not recorded in the Patent office.

The BAP determined that to establish priority against involuntarily lienholders, including the trustee in bankruptcy, the creditor must perfect its interest pursuant to the terms of Article 9. A recording with the Patent and Trademark Office is insufficient to provide constructive notice of a transfer of a security interest. The court continued by observing that in defining transfer of ownership, in contrast to the Copyright Act, the Patent Act does not use words such as “mortgage” and “hypothecation” in addition to the term “assignment.”¹⁴ Accordingly, the Patent Act does not preempt Article

¹⁴ Section 101 of the Copyright Act reads: A “transfer of copyright ownership” is an assignment, mortgage, exclusive licenses, or any other conveyance, alienation or hypothecation of a copyright or of any of the exclusive rights comprised in a copyright, whether or not it is limited in time or place of effect, but not including a nonexclusive license. Section 205 (c) & (d) read: (c) Recordation as Constructive Notice. – Recordation of a document in the Copyright Office gives all persons constructive notice of the facts stated in the recorded document, but only if—(1) the document, or material attached to it, specifically identifies the work to which it pertains so that, after the document is indexed by the Register of Copyrights, it would be revealed by a reasonable search under the title or registration number of the work; and (2) registration has been made for the work. (d) Priority Between Conflicting Transfers. – As between two conflicting transfers, the one executed first prevails if it is recorded, in the manner required to give constructive notice under subsection (c), within one month after its execution in the United States or within two months after its execution outside the United States, or at any time before recordation in such manner of the later transfer. Otherwise the later transfer prevails if recorded first in such manner, and if

9 to the same extent that the Copyright Act does. The Patent Act however, does provide priority rules for subsequent mortgages and purchasers, and thus no such transfer is effective against such parties in the absence of a recordation of the transfer in the PTO.

The case of *City Bank and Trust Co. v. Otto Fabric, Inc.*¹⁵ offers an illustration of the adverse consequences that can befall creditors who are confused by the language of the Patent Act and its relationship to Article 9 and the Bankruptcy Code. In *Otto Fabric*, Creditor recorded a transfer of an interest in debtors patents in the Patent Office within 90 days of debtor's bankruptcy. It had also previously filed an Article 9 financing statement, outside of the 90 day period. The bankruptcy trustee argued that the security interest ought to be avoided as a preference since a recordation of creditor's interest was made during the preference period. The bankruptcy court held, in reliance on the comments to section 9-302 stating that "the federal patent assignment statute occupies the field of filing." The bankruptcy court concluded that the recordation of the security interest in the Patent Office perfected secured creditor's interest, and because such perfection was within 90 days of bankruptcy, the transfer was an avoidable preference.¹⁶ The bankruptcy court also observed that a "single and absolute system of securing a creditor's interest in patents as collateral" was preferable, and this conclusion was supported by case law.¹⁶ "Requiring both federal and U.C.C. filing to perfect a creditor's interest in a patent would be contrary" to the purpose of Article 9, which is to provide "a rational and convenient filing system for security interests."¹⁷

The District Court disagreed with the bankruptcy court's findings and conclusions citing several independent grounds.¹⁸ First, the court

taken in good faith, for valuable consideration or on the basis of a binding promise to pay royalties, and without notice of the earlier transfer. 17 U.S.C. § 101, 205 (c) & (d) (1994).

¹⁵ *City Bank and Trust, Co. v. Otto Fabric*, 83 B.R. 780, 781-82 (D. Kan. 1988).

¹⁶ *In re Otto Fabric, Inc.*, 55 B.R. 654 (Bankr. D. Kan. 1985).

¹⁷ The Bankruptcy Court cited in support of its conclusion that a patent may be assigned as collateral for a loan *Waterman v. Mackenzie*, 138 U.S. 252, 260 (1891); *Magnuson Industries, Inc. v. Co-Rect Products, Inc.*, 676 F.2d 703 (8th Cir. 1981); *Railex Corporation v. Joseph Guss & Sons, Inc.*, 40 F.R.D. 119 (D. D.C. 1966). It further observed that two circuits have noted that the patent assignment statute "does not require recording to support the validity of an assignment, except as to subsequent purchasers or mortgagees without notice, and by implication recognizes the validity as to all others." *Citing, Why Corporation v. Super Ironer Corporation*, 128 F.2d 539, 541 (6th Cir. 1942); *John Tuman & Sons, Inc. v. Basse*, 113 F.2d 928 (2nd Cir. 1940).

¹⁸ *In re Otto Fabric, Inc.*, 55 B.R. 654 (Bankr. D. Kan. 1985).

¹⁹ *City Bank and Trust v. Otto Fabric*, 83 B.R. 780.

observed that the “federal statute does not expressly state that one must file an assignment with the Patent and Trademark Office to perfect a security interest. . . . If Congress intended to preempt the field of filing, it could have said so.”¹⁹ Second, the language of Section 261 of the Patent Act says that recordation in the Patent Office is necessary to protect against the interests of a “subsequent purchaser or mortgagee” and makes no mention of lien creditors. Thus, the court continued, the federal statute leaves open “a state filing to protect one’s security interest in a patent against a lien creditor.”²⁰ Finally, the court concluded, “to require a federal filing and thus a collateral assignment to perfect a security interest in a patent seems inconsistent with the modern notion that a grant of a security interest need not include the conveyance of title or ownership rights.”²¹

(ii) Perfection of Security Interests in Trademarks

Similar to the Patent Act, the Lanham Act provides for the recordation of assignments of trademarks, together with trademark holders’ goodwill. The Lanham Act, however, does not define the term “assignment” and as is the case under the Patent Act, it fails to expressly provide a system for perfecting security interests in trademarks. Because of the absence of such a specific provision, courts have held that Article 9 of the U.C.C. is the body of law governing the issue of how one perfects a security interest in a trademark -- while acknowledging that this subject “involves a trap for the unwary.”²²

The court in *In re Together Development Corp.*, in examining this issue, looked at the historical antecedents to the term “security interest” in order to determine whether an “assignment” would generally be thought of as a security interest. The court observed that, in 1946, the year the Lanham Act was passed, most security interests were referred to as “chattel mortgages” or “conditional sales.” Prior to the enactment of Article 9 in the early 1960’s, most non-possessory pledges of interests in personal property were called “mortgages” or “hypothecations.” An assignment was deemed to be a transfer of a different nature.

The court continued by examining the reference in the Lanham Act

²⁰ *Id.*

²¹ *Id.*

²² *Id.*

²³ *In re Together Development Corporation*, 227 B.R. 439, 440-441 (Bankr. D. Mass. 1998).

to phrase “successor to the business,” concluding that Congress must have had in mind “an outright assignment in the context of the sale of an entire business of which the trademark is a part.” Moreover, the court noted the express reference in the Copyright Act to the transfer of “mortgages” and concluded that the Lanham Act’s language concerning the transfer of interests fails to provide a method of perfecting security interests in trademarks.²³ Thus, the court concluded, Article 9 governs the issue of perfection of security interests in trademarks.

This position is consistent with the progeny of cases that have consistently held that the Patent Act does not preempt Article 9 and that the Article filing office is the proper place to perfect a security interest in trademarks. In *Roman Cleanser v. National Acceptance Co.*,²⁴ the court held that a security interest in a trademark is properly perfected by filing under Article 9, and such a transfer of interest is not equivalent to an assignment, which must be recorded in the Patent and Trademark Office. In *In re 199Z, Inc.*, the creditor recorded its interest in the PTO, as well as filed an improper financing statement under Article 9.²⁵ The court, in finding the secured creditor’s interest to be unperfected, held that the Lanham Act does not preempt Article 9 because it does not expressly include provisions for recording security interests within its scope.²⁶

B. Characterization of Intellectual Property when used as Collateral

Another concern central to the issue of the proper steps for perfection of security interests is how to characterize specific types of intellectual property for commercial law purposes. To illustrate, it is not necessarily clear how to properly characterize computer software. A prospective lender seeking to take a security interest in such software must first determine whether this software is copyrightable, patentable or protected as a trade secret, or characterized pursuant to Article 9, as “intangibles,” or “ordinary goods.”²⁷ If a copyright has been registered

²⁴ *Id.* at 441.

²⁵ *Roman Cleanser v. National Acceptance Co.*, 802 F.2d 207 (6th Cir. 1986).

²⁶ *In re 199z, Inc.*, 137 B.R. 778 (Bankr. C.D. Cal. 1992).

²⁷ *See id.*

²⁸ Moreover, if software is embodied in goods that are normally used in more than one jurisdiction, the software, if deemed to be an Article 9 asset, may be deemed to be “mobile goods.” If the intellectual property embodied in the software is deemed to be general intangibles, the secured party must file a financing statement in the state where

describing, with specificity, the software, then the place to register and thus perfect a security interest may be the Copyright Office. If however, a business method patent has been registered with the Patent and Trademark office, it may be deemed to be a general intangible, with the perfection location dictated by Article 9.²⁸

The extent to which the software is determined to be copyrightable or patentable in the first instance, as well as how one perfects a security interest in an unregistered copyright, or in after acquired copyrights remains unclear. The number of unanswered questions that are raised by this one commercial scenario make the collateralization of many potentially patentable materials an uncertain venture and accordingly, creditors particularly vulnerable in bankruptcy.

AVOIDANCE OF SECURITY INTERESTS AS PREFERENCES AND FRAUDULENT CONVEYANCES

A. Preferential Transfers in Bankruptcy

Another important bankruptcy context for the confusion over perfection is found in the area of preference law. The Bankruptcy Code allows for the avoidance of certain preferential transfers made upon the eve of bankruptcy. Section 547 of the Bankruptcy Code requires a two-step inquiry to determine whether a given transfer qualifies for preferential avoidance. Section 547(b)²⁹ sets forth seven elements that must be

the debtor is located. Cases have held that software products are to be as “ordinary goods,” thus requiring a state law filing in the place where the “last event occurs on which is based the assertion that the security interest is perfected or unperfected.” It should be noted that Revised Article 9 overrules the “software as ordinary goods” case law and defines software as a general intangible. Financing statements with respect to general intangibles are to be filed in the place the debtor is located, which in the case of an organized entity, is in its place of organization. See Revised U.C.C. § 9-102(a)(42) & (75), 9-307(b) & (e) (1999).

²⁹ See U.C.C. § 9-103(3)(1997). Under revised Article 9 the place to file with respect to all collateral is debtor’s “location,” which is defined for corporate debtors as its state of organization. See Revised U.C.C. §§ 9-301, 307 (2000).

³⁰ 11 U.S.C. § 547(b) reads: [T] trustee may avoid the transfer of an interest of the debtor in property B

(1) to or for the benefit of creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

established to prove an avoidable preference. These elements include (i) a transfer,³⁰ (ii) of an interest in the debtor's property,³¹ (iii) to or for the benefit of a creditor,³² (iv) for or on account of an antecedent debt,³³ (v) made while the debtor was insolvent,³⁴ (vi) made on or within 90 days of

(3) made while the debtor was insolvent;

(4) made B

(A) on or within 90 days before the date of the filing of the petition; or

(B) between 90 days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

(5) that enables such creditor to receive more than such creditor would receive if B

(A) the case were a case under chapter 7 of this title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provide.

³¹ Section 101(54) of the Bankruptcy Code broadly defines transfer to include: . . . every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor's equity of redemption. 11 U.S.C. § 101(54) (1997).

Accordingly, the perfection of security interests, title transfers, and payments to creditors all fall within the definition of "transfer" under the Bankruptcy Code..

³² In order to be subject to preference avoidance, the transfer must be of property the debtor.

³³ Section 101(10)(A) of the Bankruptcy Code defines "creditor" as "an entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor." 11 U.S.C. § 101(10)(A) (1997). "Claim" is broadly defined as a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured." 11 U.S.C. § 101(5)(B) (1997). Because one of the stated justifications for preference avoidance is to ensure equitable treatment among similarly situated creditors, it follows that the transferee have the status of a creditor with a claim to debtor's bankruptcy estate.

³⁴ The Bankruptcy Code does not specifically define the term "antecedent debt." Cases have determined that for a debt to be antecedent pursuant to § 547, the transfer must come after the date of the incurrence of the debt.

³⁵ The classic definition of an insolvent debtor is one whose liabilities exceeds it assets. Section § 101(32) of the Bankruptcy Code defines "insolvent" as a "financial condition such that the sum of the entity's debts is greater than all of such entity's property, at fair valuation. . .". 11 U.S.C. § 101(32) (1997). The insolvency test is applied on the date the transfer is made. If a debtor is solvent at the time of the transfer in question, and later becomes insolvent and is insolvent at the time of bankruptcy, the insolvency test is not met, and the transfer is not vulnerable to preferential avoidance. The timing rules of Section 547(e) come into play in determining a debtor's solvency at the time of transfer, because the date a transfer is made may be determined with reference to the § 547(e)(2)(B) grace period. Section 547(f) sets forth a presumption of

bankruptcy³⁵ (vii) that enables such creditor to receive more than they would receive under a chapter 7 distribution.³⁶ If the trustee proves all seven elements,³⁷ the trustee has established its *prima facie* case for a preference, and the transferee then has the burden of proving that one of the Section 547(c) exceptions applies.³⁸ Section 547(c) describes eight different

insolvency during the 90 days preceding the bankruptcy filing. 11 U.S.C. § 547(f) (1999). This provision's legislative history explains the impetus behind the enactment of the presumption of insolvency during the 90 days prior to bankruptcy:

Given the state of most debtor's books and records, such a task is nearly impossible. Given the financial condition of nearly all debtors in the three months before bankruptcy, the task is also generally not worth the effort. Rarely is a debtor solvent during the three months before bankruptcy. Thus, the preference section requires the trustee prove a fact that nearly always exists yet never can be proven with certainty. . . H.R. Rep. No. 595, 95th Cong., 1st Sess. 178 (1977).

The burden is placed on the creditor to rebut this presumption, which likely will involve an examination of debtor's books and records and a valuation of its assets. In the case of a challenge to a transfer made to or for the benefit of an insider beyond the 90 days prior to bankruptcy, the trustee is not granted the benefit of a presumption, and must prove insolvency with reference to the debtor's records.

³⁶ Any transfer challenged as a preference must be made, if to a non-insider, within 90 days prior to debtor's bankruptcy filing. Transfers are potentially avoidable if made within one year of bankruptcy if the transferee is an "insider." "Insider" is defined under the Bankruptcy Code to include, a relative of the debtor or of a general partner of the debtor, a partnership in which the debtor is a general partner, a general partner of the debtor, or a corporation of which the debtor is a director, officer, or person in control.

If the debtor is a corporation, an insider is deemed to be a director of the debtor, an officer of the debtor, a person in control of the debtor, a partnership in which the debtor is a general partner, a general partner of the debtor, and a relative of a general partner, director, officer, or person in control of the debtor. See 11 U.S.C. § 101(31) (1997).

³⁷ The final focus of the preference analysis is "upon whether the creditor would have received less than a 100% payout in a Chapter 7 liquidation." See *Smith v. Creative Financial Management, Inc.* (*In re Virginia-Carolina Financial Corp.*), 954 F.2d 193, 193 (4th Cir. 1992). This test requires a comparison between the value of what the creditor received as a result of the transfer, and what the creditor would have received in a hypothetical chapter 7 liquidation, absent the transfer. This is measured "not by what the situation would have been if the debtor's assets had been liquidated and distributed among his creditors at the time the alleged preferential payment was made, but by the actual effect of the payment as determined by when bankruptcy results." See *id.*, citing *Palmer Clay Products v. Brown*, 297 U.S. 227, 229 (1936). If the value of what was actually received is greater than the amount the creditor would have received in a liquidation, the hypothetical liquidation test is satisfied.

³⁸ In the case of a chapter 11, a debtor in possession. ". . . a debtor in possession shall have all the rights, other than the right to compensation under section 330 of this title, and powers, and shall perform all the functions and duties. . . of a trustee serving in a case under this chapter." See 11 U.S.C. § 1107 (1997).

³⁹ Not all transfers made while the debtor is insolvent are deemed under the bankruptcy

circumstances in which an otherwise avoidable preferential transfer is granted a safe harbor from avoidance. These circumstances include (i) a contemporaneous exchange for new value,³⁹ (ii) a transfer in the ordinary course of business,⁴⁰ (iii) a transfer in connection with an enabling loan,⁴¹ (iv) a transfer followed by a subsequent advance of new value,⁴² (v) transfer made in connection with a floating lien,⁴³ (vi) statutory lien transfers,⁴⁴ (vii) transfers to satisfy domestic relations debts,⁴⁵ and (viii) transfer made in small consumer transactions.⁴⁶ While each of the seven section 547(b) elements must be present in order to find a preference, the transfer need only qualify under one of the section 547(c) safe harbors to be saved from avoidance.

To aid the trustee in its pursuit of avoidance, Section 547(f) sets forth a presumption of insolvency during the 90 days preceding the bankruptcy filing; a presumption that may only be overcome by the transferee's proof of sufficient evidence of solvency.⁴⁷ Subsection 547(e) outlines the governing rules that define when a transfer is deemed to be made.⁴⁸

The time of the transfer relative to the time the debt was incurred

code to be preferential. Some transfers are deemed beneficial, notwithstanding the bankruptcy process. *See* 11 U.S.C. § 547(c)(1) - (8) (1997) Section 547(g) reads: "For purposes of this section, the trustee has the burden of proving the avoidability of a transfer under subsection (b) of this section, and the creditor or party in interest against whom recovery or avoidance is sought has the burden of proving the nonavoidability of a transfer under subsection (c) of this section." *See* 11 U.S.C. § 547(g) (1997).

⁴⁰ *See* 11 U.S.C. § 547(c)(1) (1997).

⁴¹ *See* 11 U.S.C. § 547(c)(2) (1997).

⁴² *See* 11 U.S.C. § 547(c)(3) (1997).

⁴³ *See* 11 U.S.C. § 547(c)(4) (1997).

⁴⁴ *See* 11 U.S.C. § 547(c)(5) (1997).

⁴⁵ *See* 11 U.S.C. § 547(c)(6) (1997).

⁴⁶ *See* 11 U.S.C. § 547(c)(7) (1997).

⁴⁷ *See* 11 U.S.C. § 547(c)(8) (1997).

⁴⁸ This presumption only aids the trustee in cases where the transfer is made during the 90 days before a bankruptcy filing. For transfers made to insiders more than 90 days (but less than one year) before bankruptcy, the burden is the on trustee to prove insolvency, in the absence of a presumption. *See* 11 U.S.C. § 547(f) (1997).

⁴⁹ *See* 11 U.S.C. § 547(e) (1997). In addition, § 547(a) provides the definition of "inventory", "new value" and "receivable." *See* 11 U.S.C. §§ 547(a)(1), (a)(2) & (a)(3) (1997).

is of critical importance to a preference analysis. When filing or recordation is necessary to “perfect” the transferee’s interest, Section 547(e)(2)(B) is implicated. Because of the requirement that the transfer must be on account of an antecedent debt, the focus of the timing analysis is on whether there is a “gap” between the incurrence of the debt and the time of the transfer. The “antecedent debt” test is satisfied if the debt is incurred before, or antecedent to the date the transfer.⁴⁹

Section 547(e)(2)(B) sets forth a ten day grace period within which transfers of interests may be perfected. With respect to security interests, this grace period begins on the date of attachment.⁵⁰ If the transfer is perfected within the grace period, the date of the attachment will be deemed to be the date of the transfer.⁵¹ If, however, the transferee perfects its interest beyond ten days from the date of attachment, the transfer is deemed to take place on the date of perfection.⁵² If due to confusion and uncertainty as to how to perfect a security interest in patents or trademarks, the perfection is delayed beyond ten days from the date of the security interest attachment, the transfer is deemed to be a transfer “on account of an antecedent debt.” If this happens within 90 days of a bankruptcy filing, the transfer is a preference subject to avoidance under § 547(b).⁵³

The case of *City Bank and Trust Co. v. Otto Fabric* (discussed above) provides a telling illustration of the trouble a creditor with an interest in patents or trademarks may find itself in when its debtor files for bankruptcy – even if it properly perfected its interest outside of the 90 day preference period. While ultimately reversed by the District Court, the bankruptcy court initially found that the recordation of a transfer of an interest in a patent in the Patent Office within the 90 day preference period

⁵⁰ The justifications for the preference rules support the necessity of the requirement of transfers made on account of antecedent debt. If a debt is incurred contemporaneously with a transfer, there is no depletion of value from the estate as a result of such transfer. If creditors contribute value commensurate with their receipt of transfers of value, other creditors are not subject to harm.

⁵¹ . . . A transfer is made . . . (A) at the time such transfer takes effect between the transferor and the transferee, if such transfer is perfected at, or within 10 days after, such time, . . . 11 U.S.C. § 547(e)(2)(A) (1997).

⁵² If the section 547(e)(2)(A) grace period has not expired at the time bankruptcy is filed, the transferee may perfect its interest within the three month grace period without violating the automatic stay. See 11 U.S.C. § 362(b)(3) (1997).

⁵³ See 11 U.S.C. § 547(e)(2)(A) (1997).

⁵⁴ Notwithstanding the satisfaction of each of the section 547(b) elements of a preference, the transfer could still be saved if it falls within one of the “safe harbor” exceptions of section 547(c). See 11 U.S.C. § 547(c) (1997).

was a preferential transfer. It appears in this case that the secured creditor was unsure as to the proper place to file to perfect its security interest, and thought the prudent course was to take a “belt and suspenders” approach.

While not ultimately fatal to its interest in the collateral, it took two written opinions to reach the ultimate conclusion that the proper place to perfect a security interest in a patent is the Article 9 filing office.

B. Transfers of License Interests as Preferences

As noted above, to qualify as a preference, a transfer must be on account of an antecedent debt. The date a debt is deemed to have been incurred turns on a non-bankruptcy law determination. When intellectual property is transferred as collateral or loan repayment or to otherwise secure an obligation, the debt is deemed to arise once the obligation becomes enforceable.⁵⁴ Debts incurred in connection with absolute assignments of intellectual property are deemed to arise at the time title or control is transferred. When intellectual interests are licensed, However, the time the debt is incurred is less straightforward.

If one looks at an intellectual property license as analogous to a real estate lease, the debt would be deemed to have been incurred contemporaneously with each periodic payment transfer. Accordingly, each transfer of a license interest would be on account of a contemporaneous debt.

An alternative view of a license for the use or exploitation of a patent or trademark, however, has the potential to raise some troubling preference issues. If the language of the license, or the context, suggests a one-time transfer of rights in exchange for periodic payments, then the debt would be deemed to have been incurred at the time the license agreement was entered into. Thus, each license payment would be considered a transfer on account of an antecedent debt. If a debtor files for bankruptcy during the term of the license agreement, any payments made (on account of an antecedent transfer of rights) within 90 days of bankruptcy are subject to avoidance as preferences.

C. Avoidance of Fraudulent Conveyances

Fraudulent conveyances are transfers prior to bankruptcy, made with either actual fraud, or with what is known as constructive fraud. When

⁵⁵ City Bank v. Otto Fabric, 83 B.R. 780, 781-82 (D. Kan. 1988).

a debtor is in bankruptcy, the Bankruptcy Code gives the trustee the power to avoid transfers qualifying as fraudulent under two independent provisions.

Section 544(b) allows the trustee to avoid any transfer “by the debtor that is avoidable under applicable law by a creditor holding an unsecured claim that is allowable.”⁵⁶ What this means is that any transfer that could be avoided by a creditor under state fraudulent conveyance act can be avoided by the trustee in bankruptcy.⁵⁶ This provision allows the trustee to avoid transfers made within the state-law “look-back” period -- which can be as long as four years. Section 548 of the Bankruptcy Code gives the trustee powers to avoid fraudulent transfers without requiring that there be an unsecured creditor with an avoidable claim in bankruptcy.⁵⁷ The section 548 “look-back” period is one year.

Section 548 fraudulent conveyance law may be implicated when patents and trademarks are used as collateral for reasons similar to those discussed with respect to preferences. For there to be a fraudulent transfer, there must be a transfer of an interest -- and the transfer of a security interest qualifies under this provision. If the security interest transfer is perfected within the “look-back” period, the transfer, if meeting the criteria for avoidance under section 548 or under state fraudulent conveyance law, is subject to avoidance. If due to confusion and uncertainty as to how to perfect a security interest in patents or trademarks, the perfection is delayed and spills into the look-back period, the transfer is vulnerable to defeat by the trustee as a fraudulent conveyance.

⁵⁶ 11 U.S.C. § 544(b) (1997).

⁵⁷ To use section 544(b), there must be a creditor with an allowable claim in debtor's bankruptcy that could have avoided the transfer under state law.

⁵⁸ Section 548(a)(1) reads: The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of filing of the petition, if the debtor voluntarily or involuntarily—(A) made such transfer or incurred such obligation with actual intent to hinder, delay or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or (B) (i) received less than a reasonably equivalent in value in exchange for such transfer or obligation and (ii) (I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation; (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured. 11 U.S.C. § 548(a) (1997).

APPENDIX 27 - DEFINITIONS

Accessions -	Goods that are physically united with other goods in such a manner that the identity of the original goods is not lost. U.C.C. § 9-102(a)
Accounts -	A detailed statement of the mutual demands in the nature of debit and credit between parties, arising out of contracts or some fiduciary relation. Black's Law Dictionary 18 (6 th ed. 1990)
Account debtor -	The person who is obligated on an account, chattel paper or general intangible. U.C.C. § 9 – 105(1)(a).
After-acquired - Property clause	A clause in a mortgage providing that any property acquired by the borrower after the date of the loan and mortgage will automatically become additional security for the loan. Black's Law Dictionary 61 (6 th ed. 1990)
Assignment -	The act of transferring to another all or part of one's property, interests, or rights. Black's Law Dictionary 119 (6 th ed. 1990)
Attachment -	When the three basic prerequisites of a security interest exist (agreement, value, and collateral), the security agreement becomes enforceable between the parties and is said to "attach". Black's Law Dictionary 126 (6 th ed. 1990)
Bona fide purchase rule -	When a legal title holder of a patent transfers his or her title to a third party purchaser for value without notice of an outstanding equitable claim or title, the purchaser takes the entire ownership of the patent, free of any prior equitable encumbrance. This report p. 121
Chattel paper -	A writing or writings which evidence both a monetary obligation and a security interest in or a lease of specific goods. Black's Law Dictionary 237 (6 th ed. 1990)
Commercial Tort claim -	All business-related tort claims that do not involve personal injury or death.
Condition	A condition which is to be performed before some right
Precedent	dependent thereon accrues, or some act dependent thereon is performed. Black's Law Dictionary 293 (6 th ed. 1990)
Constructive - Notice	Such notice as is implied or imputed by law, usually on the basis that the information is a part of a public

	record or file, as in the case of notice of documents which have been recorded in the appropriate registry of deeds or probate. Black's Law Dictionary 314 (6 th ed. 1990)
Derivative title -	The common-law principle, codified repeatedly in the U.C.C., that a transferee of property acquires only the transferor's rights therein. Black's Law Dictionary 444 (6 th ed. 1990)
Dicta -	Opinions of a judge which do not embody the resolution or determination of the specific case before the court. Black's Law Dictionary 454 (6 th ed. 1990)
Financing Statement -	A document setting out a secured party's security interest in goods. Black's Law Dictionary 631 (6 th ed. 1990)
Federal Intellectual Property Securities Act (FIPSA) -	A comprehensive package of amendments to the tract recording provisions of the Copyright Act, the Lanham Act, the Patent Act and the Semiconductor Chip Protection Act. This report p. 12
General intangible -	Any personal property (including things in action) other than goods, accounts, contract rights, chattel paper, documents, instruments, and money. Black's Law Dictionary 684 (6 th ed. 1990)
Goods -	All things that are moveable when a security interest attaches. U.C.C. § 9-102(a)
Instrument -	A negotiable instrument or any other writing that evidences a right to the payment of a monetary obligation, is not itself a security agreement or lease, and is of a type that in ordinary course of business is transferred by delivery with any necessary endorsement or assignment. U.C.C. § 9-102(a)
Lanham Act -	Federal statute enacted in 1946 which revised federal trademark law and registration process. Black's Law Dictionary 880 (6 th ed. 1990)
Lien creditor -	One whose debt or claim is secured by a lien on particular property, as distinguished from a "general" creditor, who has no such security. Black's Law Dictionary 923 (6 th ed. 1990)
Mask works -	Term referring to the set of templates or "masks" that together make up the design of a semiconductor chip. The chip manufacturer uses these masks in a photographic depositing and etching process to build up the three-dimensional structure of the chip. This report p.15
Perfection -	In secured transactions law, the process whereby a security interest is protected, as far as the law permits,

	against competing claims to the collateral, which usually requires the secured party to give public notice of the interest as by filing in a government office. Black's Law Dictionary 1137 (6 th ed. 1990)
Preemption Doctrine -	Doctrine adopted by the U.S. Supreme Court holding that certain matters are of such a national, as opposed to local, character that federal laws preempt or take precedence over state laws. Black's Law Dictionary 117 (6 th ed. 1990)
Priority -	In bankruptcy, refers to secured claims that by statute receive more favorable treatment than other unsecured claims. Black's Law Dictionary 1194 (6 th ed. 1990)
Proceeds -	<p>The following property:</p> <ul style="list-style-type: none">A) whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral;B) whatever is collected on, or distributed on account of, collateral;C) rights arising out of collateral;D) to the extent of the value of collateral, claims arising out of the loss, nonconformity, or interference with the use of, defects or infringement of rights in, or damage to, the collateral; orE) to the extent of the value of collateral and to the extent payable to the debtor or the secured party, insurance payable by reason of the loss or nonconformity of , defects or infringement of rights in, or damage to, the collateral. U.C.C. §9-102(a)
Purchase-money security interest -	One which is taken or retained by seller of item to secure its price or taken by person who advances funds to enable one to acquire rights in collateral. Black's Law Dictionary 1235 (6 th ed. 1990)
Security Interest -	A form of interest in property which provides that the property may be sold on default in order to satisfy the obligation for which the security interest is given. Black's Law Dictionary 1357 (6 th ed. 1990)
Service -	Duty or labor to be rendered by one person to another, the former being bound to submit his will to the direction and control of the latter. Black's Law Dictionary 1368 (6 th ed. 1990)
Software -	A computer program and any supporting information provided in connection with a transaction relating to the program. This report p. 25
Uniform Commercial Code -	One of the Uniform Laws drafted by the National Conference of Commissioner's on Uniformed State

Laws and the American Law Institute governing commercial transactions. Black's Law Dictionary 1531 (6th ed. 1990).

Valuable consideration -

A class of consideration upon which a promise may be founded, which entitles the promisee to enforce his claim against an unwilling promisor. Black's Law Dictionary 1550 (6th ed. 1990)

Venture capital –

Funding for new companies or others embarking on new or turnaround ventures that entails some investment risk but offers the potential for above average future profits. Black's Law Dictionary 1556 (6th ed. 1990)